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STOCK OPTIONS BACKDATING

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

THE PRACTICE OF RETROACTIVELY CHANGING GRANT DATES IN ORDER FOR EXECUTIVES TO BENEFIT FROM A LOWER EXERCISE PRICE.

WEDNESDAY, SEPTEMBER 6, 2006

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C O N T E N T S

WEDNESDAY, SEPTEMBER 6, 2006

WITNESSES

Additional Material Supplied for the Record

STOCK OPTIONS BACKDATING

WEDNESDAY, SEPTEMBER 6, 2006

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:10 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Richard Shelby, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN SHELBY

Chairman SHELBY. Good morning. The Committee will come to order.

This morning the Committee revisits the issue of employee stock options. In the last Congress the Financial Accounting Standards Board proposal requiring that companies recognize options as a compensation expense in financial reports generated much controversy. Indeed, there was an intense lobbying campaign to thwart FASB's efforts.

But I believed then, as I do now, that the Board's independence to establish generally accepted accounting principles without political interference must be preserved. That is the only way to ensure that the preeminent goal of financial reporting is accuracy rather than politically expedience.

As a result of FASB's project, the fair value of all stock options as of the grant date must now be shown on corporate income statements. Investors will benefit from this enhanced transparency.

We are not here today to re-examine the expensing issue. Rather we meet to consider the practice known as stock options backdating. Almost 10 years ago an academic study noted favorable stock patterns following option grants. The study's author concluded that the rises in stock prices occurred because executives knew favorable company news was coming and timed the grants just before it.

Groundbreaking research published last year by Professor Erik Lie, who is going to be one of our witnesses this morning, indicated that something else led to the post-grant stock gains. The grant dates were almost certainly retroactively changed in order for executives to benefit from a lower exercise price.

In his testimony later today, he will cite an unpublished study he conducted with another professor. There Dr. Lie concluded that 29 percent of firms that granted options to top executives between the years 1996 and 2005 manipulated one or more option grants in some fashion.

These findings raise some serious questions about the accuracy of financial reporting during the period, even assuming that they are only remotely accurate.

In March the Wall Street Journal published a widely discussed statistical analysis revealing highly improbable timing of option grants at several companies. For example, all six of the option grants awarded to the chief executive of Affiliated Computer Services were dated just before a rise in the stock price, often at the bottom of a steep drop. The odds of this happening by chance were around one in 300 billion.

At another company, UnitedHealth Group Inc., the chief executive received option grants in 1997, 1999 and 2000 that were dated the same day the company's stock hit its low for those years. The Journal estimated the odds of such a favorable pattern occurring by chance would be at least one in 200 million.

Intentional and undisclosed manipulations of grant dates appears to be a black-and-white example of securities fraud. Corporate officers and directors engaging in this practice are cheating the owners of the company, who are the stockholders, and should be held accountable to the fullest extent possible. I am confident that this will happen.

I understand that the Securities and Exchange Commission is currently investigating at least 100 companies for potential backdating abuses. It has been suggested that it would have been much more difficult, if not nearly impossible, to backdate option grants had the accounting rules required expensing in the 1990's. Accountants would have been more vigilant in reviewing option grants if their expense were required to be shown on the income statement.

Today we have assembled, I believe, an excellent lineup to discuss these issues. Testifying on the first panel will be the Honorable Christopher Cox, Chairman, Securities and Exchange Commission and the Honorable Mark W. Olson, Chairman, Public Company Accounting Oversight Board.

On the second panel we will hear from Dr. Erik Lie, Associate Professor of Finance, University of Iowa; Mr. Lynn Turner, Managing Director of Research, Glass Lewis & Company, LLC and former SEC Chief Accountant; Mr. Kurt Schacht, Managing Director, CFA Centre for Financial Market Integrity; and Mr. Russell Read, Chief Investment Officer, California Public Employees' Retirement System.

We will welcome all of you for your appearance and your testimony here today.

Senator Sarbanes.

STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Chairman Shelby. And I want to thank you for holding today's hearings on a subject matter of serious concern to investors, and that is the practice of improperly backdating stock options.

Federal securities laws are predicated, in large part, on public companies making full and fair disclosure. Investors rely on companies' disclosures in their investment decisions and obviously they expect honest representations. If the company makes misleading or fraudulent statements, investors will lose confidence in the com-

pany's accounting, internal controls and management. And regrettably, if enough companies engage in this conduct, investors will begin to question the integrity of the U.S. capital markets. In fact, their reputation for integrity, I think, has been an important economic asset for the nation.

In May 2005, Professor Erik Lie, the Chairman has already referred to this study, published research that found that returns on unscheduled stock option grants by a large number of companies were abnormally high. He concluded, and I quote him "Unless executives possess an extraordinary ability to forecast the future marketwide movements that drive these predicted returns, the results suggest that at least some of the awards are timed retroactively."

Regulators are now investigating a large number of companies that may have awarded options retroactively, contrary to their stated policies. Glass Lewis reports that over 120 companies have announced that they are under regulatory investigation or are investigating themselves to determine whether they have improperly backdated stock options.

This issue has attracted broad public attention and concern. In an article "At the Options Buffet Some Got a Bigger Helping," in the New York Times in July of this year, it was noted "Investors are getting a clearer view of what these executives were doing with their beloved options. It's not pretty."

The San Francisco Chronicle, in an article in July, opined that "The real story is how stock options, once a universally cherished benefit in Silicon Valley, have led to executive abuse and erosion of the public trust."

And USA Today observed that it serves "As yet another troubling example of how shareholders are being fleeced. It would also show how a benefit designed to attract, reward and retain talented employees has been perverted."

Unfortunately, it appears that improper backdating has been widespread and gone unregulated for many years. Even after the enactment of Sarbanes-Oxley and its 2-day reporting requirement, which curtailed the problem, backdating reportedly has continued where option reports were filed late. In other words, did not comply with the statutory requirements.

The SEC and others have broad enforcement actions against former officers of companies. The SEC also, on August of this year, just a month ago, almost a month ago, published final rules that require more disclosure about option grants, particularly backdated options, and about spring-loading. Notably, the Commission received a record 23,244 public comments on this rule, showing a strong investor interest in the disclosure of executive compensation.

The PCAOB has published a staff practice alert touching on this issue.

I look forward to hearing about the scope of this significant problem, what the regulators are doing to address it, and what more should be done to prevent future problems. I am particularly interested in whether the SEC needs more resources for enforcement staff or otherwise or more authority in order to address this issue.

Mr. Chairman, I join with you in welcoming our distinguished witnesses. We are pleased to have Chairman Cox back before the

Committee, have Chairman Olson here as Chairman of the Public Company Accounting Oversight Board. He has been before us on other occasions in other capacities. This is the first time as Chairman of the PCAOB.

And of course, the second panel includes a number of distinguished witnesses, including Lynn Turner, former Chief Accountant of the SEC; University of Iowa Professor Erik Lie, whose who study we both referenced; Kurt Schacht of the CFA Institute; and Russell Read of CalPERS.

Once again thank you, Mr. Chairman, for your leadership first on the issue of expensing stock options, which we had to address in an earlier time, and now for conducting this important oversight hearing on the backdating and spring-loading of stock options.

Thank you very much.

Chairman SHELBY. Senator Bunning.

STATEMENT OF SENATOR BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

I am glad we are taking the time to look at the backdating of stock options and any improper or criminal action that may have happened. It is an issue that not only affects companies and auditors, but also investors' confidence.

I commend Professor Lie for his work in bringing this issue to everyone's attention. His work and the ongoing SEC investigation show that our disclosure rules provide investors and regulators with valuable information about what public companies are doing.

The SEC is also working on new executive compensation disclosure rules that would provide us with even more information on option grants.

With the passage of Sarbanes-Oxley in 2002, Congress reduced the time that directors, officers and principal stock holders have in reporting stock options grants from 45 days to 2 days. That effectively ended the backdating that occurred in the 1990's and the early 2000's. In other words, backdating appears to be a problem of the past.

I am interested to hear from our witnesses today about their findings on the current options granting practices.

We can all agree that those who willfully mislead and defraud shareholders should be published. Anyone who broke the law should be published. And any accounting problem should be fixed. So far it appears that the SEC and other Government agencies have the power they need to punish wrongdoers, so I think we should be careful not to overreact by further regulating how companies compensate their employees.

I look forward to hearing from our witnesses. Thank you very much, Mr. Chairman.

Chairman SHELBY. Thank you. Senator Menendez.

STATEMENT OF SENATOR MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman.

Let me thank you and the ranking member for holding a very important and timely hearing on the backdating of stock options.

It seems to me that to protect New Jersey families, families across this nation, and their retirement security, we have to have

financial markets that are transparent, accurate and full of integrity.

As we know, backdating is the practice of moving the date for stock option grants to ensure an exercise price below the fair market value of the stock on the date of the grant, and thus, a bigger payday for the receiver of the option.

Perhaps even more widespread than option backdating is the practice of timing a grant of options to take advantage of anticipated market reactions to a forthcoming public announcement by the company. This practice, which has been referred to and commonly known as the option spring-loading, has also come under scrutiny in the last several months.

I believe we have to get to the bottom of the true size of this stock option problem. We know that there are over 100 companies that have come under scrutiny for past stock option grants, and this includes companies that have disclosed Government investigations, misdated options, or have made restatements. However, some researchers believe the actual number of companies that may be affected is up to 10 times that figure.

In addition, these practices occurred over several years. One or two entities have already been delisted on a market because they could not file financials. Others have had enforcement actions taken against them. And still others have fired executives and members of their boards.

Imagine the potential impacts this situation could have, not only for investors across this country but for the financial markets themselves.

And this is not a victimless crime. Could this be the Enron of 2006?

When this hearing was announced, I thought about the various implications that the backdating of stock options without disclosure could have. Under securities law, a company and its CEO and CFO may be liable under the Securities Exchange Act of 1934 for filing false and misleading financial statements that did not properly account for the grant of discounted options and may also be liable for other public disclosure of executive compensation that did not describe such discounted options. So the company would be in violation of its option plan on file with the SEC and open to investigation for potential securities fraud.

A company could also face accounting issues. Under rules used in accounting, a company that has backdated stock options would have to amend financial statements to reflect the compensation expense resulting from the difference between the lower exercise price and the higher stock option on the actual grant date.

And finally, the Internal Revenue Service has announced investigations of more than 40 companies to determine whether they owe taxes related to option backdating. From the company's, prospective discounted options do not qualify as "performance-based compensation" that is otherwise exempt from the $1 million limit on the deduction of compensation paid to company's top officers. A company that has improperly treated certain options as having been granted at fair market value may have overstated its profits and would have to restate earnings to account for the lost deduction.

Several shareholder derivative suits have already been filed against companies accused of option backdating. In addition, such actions could potentially cause a company's stock to fall, which would impact those that have invested in the company.

So what I hope to find out today is whether we have a better idea of the size of this backdating problem and whether the rules on the books are both enough to stop this practice from occurring anymore, while also allowing for effective prosecution. Our responsibility is to ensure the objectivity and independence of such investigations so that there is greater public confidence in stock option grants and in our financial markets while we protect the retirement security of American families.

Mr. Chairman, I look forward to the testimony.

Chairman SHELBY. Thank you. Senator Allard.

STATEMENT OF SENATOR ALLARD

Senator ALLARD. Mr. Chairman, I want to thank you for the hearing.

And as a former small-business owner, I know a difficult and challenging it can be to attract and retain top quality staff, especially for positions that require a lot of education and experience. Startup companies obviously have found stock options one way to meet that challenge. We understand that.

I also understand that companies have used stock options to motivate their employees, because they get to share in the profits of the company at the time that those are issued and collected on.

While stock options provide both benefits to employees and the owners themselves, the companies, obviously there are rules that must be followed when granting stock options. And these rules help ensure the integrity of information reported to shareholders and the marketplace.

Unfortunately, I understand not all companies have followed the rules, and I commend the SEC for investigating possible instances of backdating stock options and I will be eager to hear the results of the investigation thus far.

I also commend the SEC, IRS and PCAOB and others for taking steps to correct any financial misstatements that may have occurred as a result of stock option backdating. Fair and efficient markets rely upon the accuracy of financial information.

While it appears that Sarbanes-Oxley and FASB action have helped stem the occurrence of backdating, I will be eager to hear from our witnesses regarding whether they believe any further safeguards are necessary.

I would like to thank all of our witnesses for taking the time to be here today. I look forward to your testimony.

Chairman SHELBY. Thank you. Senator Crapo.

STATEMENT OF SENATOR CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman.

I think that historically we have seen that stock options have been a very effective tool for companies to be able to attract the talent and the people that they need to be competitive and to help our economy to remain on the competitive edge.

Recent events have also shown us that this tool can be abused. It seems to me that we've got an extremely well-qualified panel, a couple of panels, of witnesses here today who can help us to find the right line in terms of where the regulatory balance should be in managing and operating the use of stock options while still allowing them to be a viable tool for those companies that can utilize them in the proper way to be a strong part of our economy and to help our nation continue to be the leading economy in the world.

So I am interested in the testimony of the witnesses today and appreciate the fact that you have brought this hearing forward.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bennett.

STATEMENT OF SENATOR BENNETT

Senator BENNETT. Thank you very much, Mr. Chairman.

I am looking forward to the witnesses here. I have had the experience of being granted stock options as inducement to come to work as the president of a company. The number of options was quite generous, and the stock never ever got back to the level that it was when I joined the company. As a consequence, I never converted any of the options and never got any of the benefit.

I am sure that had nothing to do with my talent as the president of the company, but was as a result of circumstances.

[Laughter.]

I recall here in the Congress, when we raised taxes in 1993, that we added to the tax code a provision that chief executive compensation in excess of $1 million a year could not be deducted. In other words, there would be no tax advantage to a company that paid an executive $2 million a year. There would be a tax penalty. Instead of being able to deduct the entire $2 million as a legitimate business expense, they can only deduct $1 million as a legitimate business expense. The idea was to discourage companies from paying their CEOs too much.

I will not go so far as to suggest that that was responsible for the manipulation that occurred at Enron or the temptation to backdate option grants. But certainly in the rhetoric that surrounded that particular decision on the part of the Congress, there was a great deal of talk about how valuable it would be if CEO compensation was taken away from straight cash and turned toward some kind of performance incentive like stock options.

Well, we are now here talking about companies that have manipulated stock options in order to maximize executive compensation and perhaps get around the unintended consequence that I think has occurred from what the Congress did.

I think we should remove the limit on the amount of deductibility for cash paid to a chief executive and say if a company wanted to pay its CEO $10 million in cash, it should be able to do so and deduct the entire $10 million as a legitimate business expense.

I know some CEOs who would say I would rather have the cash. The stock option thing is—I will take less if I can get it in cash, which I know is certain, rather than the uncertainty of a stock option.

So we may, in the Congress, have created an unintended incentive to cheat. That does not excuse the people who do cheat. And

I commend the SEC for their vigilance in following up on people who may have decided that a clever way to deal with this issue of compensation is to backdate options and be able to pick, after the fact, the most advantageous time at which the option becomes exercisable.

So I look forward to the hearing, Mr. Chairman, and I appreciate your vigilance in calling the hearing and bringing these witnesses before us. But I think if there needs to be congressional change in the law in response to what is going on, it might be in the jurisdiction of the Finance Committee to deal with this aspect of the tax law that was put in place over a decade ago and that, in my opinion, has not produced anything of value to the markets or to the economy as a whole.

Chairman SHELBY. Just for the record, I voted against that tax bill.

Senator BENNETT. So did I, Mr. Chairman.

Chairman SHELBY. Chairman Cox, Chairman Olson, we welcome you to the Committee. Your written testimony will be made part of the record in its entirety. Chairman Cox, we will start with you. You proceed as you wish.

STATEMENT OF CHRISTOPHER COX, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. COX. Thank you very much, Chairman Shelby, ranking member Sarbanes, and members of the Committee, for inviting me today to testify about stock options backdating.

I think the reason that this issue is one of such intense public interest is that it strikes at the heart of the relationship among a public company's management, its directors and its shareholders. I appreciate the opportunity to explain the Commission's initiatives to deal with abuses involving backdating of options.

I am especially pleased to be testifying this morning with Chairman Mark Olson of the Public Company Accounting Oversight Board. I will let Chairman Olson speak to the steps that the PCAOB is taking to address these issues from the auditing regulators' perspective, but I would like to assure the Committee and the public that the Commission is working closely with the PCAOB in this area.

There are many variations of the options backdating theme. It comes in many flavors. But here is a typical example of what some companies did. They granted an in-the-money option, that is an option with an exercise price lower than that day's market price. And they did this by misrepresenting the date of the option grant to make it appear that the grant was made on an earlier date when the market value was lower. That, of course, is what is meant by abusive backdating, in today's parlance.

The purpose of disguising an in-the-money option through backdating is to allow the person who gets the option to realize larger potential gains without the company having to show it as compensation on its financial statements.

Rather obviously, this fact pattern results in a violation of the SEC's disclosure rules. It also results in a violation of accounting rules and the tax laws. The SEC has been after this problem of abusive stock options backdating for several years.

As a preliminary step in explaining the Commission's response to this problem of abusive options backdating, it might be useful to put the whole topic of executive compensation into some perspective. As you know, during this last year the Commission has been intensely focused on the quality of disclosure of executive compensation. Very recently we enacted new rules that will require, beginning with the next proxy season, that there be full disclosure of all aspects of the top executives' compensation.

Under the new SEC rules governing executive comp, the total that a manager makes will be summed into one number so that it can be compared easily from person to person, company to company, and industry to industry. The new rules will, in particular, require more detailed disclosure about stock options. And this new disclosure will make it clearer to investors if a company has backdated options and why.

The purpose of our new executive compensation rules is to make the CEO's pay understandable to the shareholders who own the company. Of course, no new SEC rules would be necessary to make executive pay transparent if executives were all paid in the form of salary. But, beyond the obvious fact that the income tax code discriminates in favor of non-salary compensation that can be taxed as capital gains, one of the most significant reasons that non-salary forms of compensation have ballooned since the early 1990s is the $1 million legislative cap on salaries for top public companies that was added to the Internal Revenue Code in 1993.

As a Member of Congress at the time, I well remember that the stated purpose was to control the rate of growth in CEO pay. I think we can now all agree, with perfect hindsight, that that purpose was not achieved. In fact, this tax law change deserves pride of place in the museum of the unintended consequences.

There are other accounting and tax reasons as well that stock options over the years were increasingly included in compensation packages of executives and non-executives. Beginning in 1972, the accounting rule was that employee stock options would not have to be shown as an expense on the income statement so long as the terms were fixed when the option was granted, and so long as the exercise price was equal to the market price on that day.

In addition to this favorable accounting treatment, and beyond the favorable tax treatment afforded to capital gains as opposed to ordinary income, there was a further tax benefit. The $1 million cap on the tax deductibility of executive compensation, which I just mentioned, does not apply to options granted at fair market value. So, for companies that wanted or needed to pay an executive more than $1 million, the tax code outlawed the companies deducting it if it was paid in a straightforward way through a salary, but permitted a deduction to the company if the compensation was paid through at-the-money options.

Of course, there were other reasons, many of them good reasons with solid economic rationales, behind the use of options as a form of compensation. For example, a properly structured option plan can be useful in more closely aligning the incentives of shareholders and managers. And, for growth companies, the use of stock options as compensation offers a way to conserve resources while attracting top-flight talent in highly competitive job markets.

All of these factors have contributed to the now widespread use of stock options as compensation. But just as option compensation has increased, so did the potential for abuse. And Congress deserves credit for taking preemptive action that we now know was critical to stopping the spread of the backdating contagion.

Four years ago, in 2002, the Sarbanes-Oxley Act very presciently tightened up on the reporting of stock option grants. Before Sarbanes-Oxley, officers and directors did not have to disclose their receipt of stock option grants until after the end of the fiscal year in which the transaction took place. So a grant in January might not have to be disclosed until more than a year later. Sarbanes-Oxley changed that, by requiring real-time disclosure of stock options grants.

In August 2002, shortly after that law was signed, the Securities and Exchange Commission issued rules requiring that officers and directors disclose any option grants within two business days.

Not only must option grants be reported now within two business days, but this information was among the first that is now required to be reported to the SEC using interactive data. Thanks to this new data-tagging approach, economists, researchers, law-enforcement and the investing public now have almost instant access to information about stock option grants in a form that they can immediately download into spreadsheets, analyze and compare.

In 2003 the SEC took another important step that has helped increase the transparency of public company option plans. The Commission approved changes to the listing standards of the New York Stock Exchange and the NASDAQ stock market. Those, for the first time, required shareholder approval of equity compensation plans. Since then, companies have had to disclose publicly the material terms of their stock option plans in order to obtain shareholder approval.

Very importantly, the required disclosure includes the terms on which options will be granted, and companies must tell their shareholders whether the plan permits options to be granted with an exercise price that is less than the market value on the date of grant. If backdating as a means of granting in-the-money options is permitted by the plan, the disclosure has to make that fact clear.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard 123R, which effectively eliminated the accounting advantage that had previously been given to stock options issued at-the-money. Since this new accounting rule took affect, all stock options granted to employees have to be recorded as an expense in the financial statements, whether or not the exercise price is at fair market value. This rule is now almost fully phased in.

And most recently, in July of this year, the Securities and Exchange Commission adopted new rules requiring that public companies more thoroughly disclose their awards of in-the-money options to top executives. The rules also require that companies disclose the fair value of the option on the grant date as determined under the new accounting rules. And, because the dates and the numbers often do not tell the whole story, companies will also be required to discuss the policies and goals of their executive compensation plan and their stock option practices in plain English.

The reports to investors will describe whether and, if so, how a company has engaged in backdating or any of the many variations on that theme concerning the timing and pricing of options. The Commission will continue to avail itself of every opportunity to clarify the rules and procedures for options issuance going forward.

To that end, you can expect that the SEC's Office of the Chief Accountant will soon issue further public guidance on the accounting issues surrounding backdating.

Each of these steps that I have described has made an important contribution to preventing backdating abuse and its further spread. In combination, they have effectively slammed the door shut on the easy opportunities to get away with secretive options grants. That is why almost all of the stock option abuses that our enforcement division has uncovered started in the period prior to these reforms.

But, while these accounting and disclosure rule changes have made it easier to detect and punish the backdating of stock options going forward, uncovering the problems from prior years has been quite a challenge.

A few years ago the SEC began working with academics to decipher market data that provided the first clues that something fishy was going on. One of the academics with whom the SEC worked was Erik Lie with the University of Iowa who, Mr. Chairman, as you noted, is here with us today. He subsequently published a paper in 2005 that showed compelling circumstantial evidence of backdating.

Specifically the data showed that before 2003 a surprising number of companies seemed to have had an uncanny ability to choose grant dates that coincided with low stock prices. With a fair amount of detective work and with the aid of economic research conducted by the SEC's Office of Economic Analysis, the Commission succeeded in turning what had begun as mere evidentiary threads into solid leads. Eventually some of the evidence we began turning up was so compelling that several U.S. attorneys took a criminal interest.

Over the past several years, our inventory of backdating and related investigations has grown substantially. Beginning 3 years ago, the SEC has brought several enforcement actions against companies and individuals for fraudulent option practices. For example, in 2003 the Commission charged Peregrine Systems Incorporated with financial fraud for failing to record an expense for compensation when it issued in-the-money options using a look-back scheme that took the lowest price of the stock during a quarter. As a result, the company understated its expenses by approximately $90 million.

The following year, in 2004, the SEC brought a case alleging that Symbol Technologies Incorporated and its former general counsel manipulated option exercise dates so that senior executives could profit unfairly at the company's expense. The SEC charged that the company's general counsel instructed his staff to backdate the relevant documents and to substitute phony exercise dates on the forms the executives used to report their option exercises to the SEC and to the public. When the company restated its accounting for this improper backdating, it had to increase its reported expenses for options by $229 million.

Most recently, in July of this year, the SEC filed a civil fraud action against former executives of Brocade Communication Systems, alleging that the former CEO and former vice president of human resources backdated documents to make it appear that the options they granted were at-the-money, in the process concealing millions of dollars in expenses from the investing public.

In fact, the SEC's complaint alleges that the scheme resulted in the inflation of the company's net income by as much as $1 billion in a single year.

And in another recent case, the SEC charged that three former executives of Comverse Technology Incorporated engaged in a decade-long fraudulent scheme to grant undisclosed in-the-money options to themselves and to others by backdating stock options grants to coincide with low closing prices of Comverse stock.

In addition, the complaint alleges that the former CEO and CFO created a slush fund of backdated options by granting them to fictitious employees.

Both of these recent cases have resulted in criminal as well as civil charges.

The SEC's Division of Enforcement is currently investigating over 100 other companies for the possible fraudulent reporting of stock option grants. The companies are located throughout the country and include Fortune 500 companies as well as smaller cap issuers. They span multiple industry sectors.

Of course, not all of these investigations will result in enforcement actions by the SEC. At the same time, we have to expect that other enforcement actions will be forthcoming.

To summarize, Mr. Chairman, the SEC has been and will remain vigilant in the battle against fraudulent options backdating. In our rulemaking, in our provision of accounting and financial regulatory guidance, and in our enforcement program we are determined to deal aggressively with past abuses and to provide ample guidance going forward to stamp out abusive backdating once and for all.

The Agency is grateful for the opportunity to provide you with this update on an important subject. Of course, I will be happy to take your questions.

Chairman SHELBY. Chairman Olson.

STATEMENT OF MARK OLSON, CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Mr. OLSON. Thank you very much, Chairman Shelby, ranking member Sarbanes, members of the Committee. Thank you for the invite. I am also pleased to be here today with Chairman Cox.

From the perspective of the PCAOB, as the Committee knows, the PCAOB does not regulate accounting or disclosure. PCAOB's role is to oversee auditors of public companies in order to protect the interest of the investing public in order to improve the quality and reliability of public company audits.

I support the observation that a number of you have made that well managed stock options are useful and an appropriate tool to attract and retain employees. But questions have arisen about the pattern and of the timing of those options grants. And studies suggest that there may have been some retroactively assigned grant dates.

As all of you have referred to, and as we will be hearing more from Erik Lie, Professor Lie, in the second panel, the circumstances surrounding the options dating I think have been very thoroughly aired to this point. But let me just remind the Committee of a sequence of events that have, as Senator Bunning has suggested, and others have suggested, significantly narrowed the opportunity.

The first, as Chairman Cox pointed out, with the passage of Sarbanes-Oxley, 403, and the rules implementing 403, that requires a 2-day reporting for employee stock options grant has significantly reduced the opportunity for manipulation of the grant date.

Second, the sequence of accounting changes, from APB 25 to FAS–123 to 123R, that now require the accounting at fair value, also have significantly brought about a change.

Nonetheless, the PCAOB in July of this year did issue, as Senator Sarbanes suggested, the audit practice alert that summarized some of the existing literature. It summarized some of the research that had been done by us and by others regarding the timing of options and what auditors should be looking for. That was issued at the advice of our advisory council, some of the members of that council are participating on your second panel.

There continue to be certain audit issues that do arise as a result of the past practices and we are continuing our dialog with the accounting profession to assure that not only are they looking at those issues but they are establishing a risk-based focus on auditing issues that would not only uncover this but prospective issues as they would come up in the future.

I look forward to answering any questions.

Chairman SHELBY. Thank you.

Chairman Cox, can you discuss here the forensic capabilities of the SEC so we may better understand the means and the methods that the Commission has to detect and prosecute similar instances of fraud in the future?

Mr. COX. Certainly, Mr. Chairman.

In both the Division of Corporation Finance and the Division of Enforcement, we have teams assigned to monitoring the delinquent filing of Form 4s, also of other periodic reports, 10–Ks, 10–Qs, and so on.

We are also, in the Office of the Chief Economist, using both the internal data that is generated from regulatory filings and other academic analysis produced in the outside world. For example, the collaboration with Dr. Lie is one of the things that we mentioned, to drill down into these problems.

I mentioned in my testimony that the filings on Form 4 of the options grants were among the first that were required to be filed in interactive data format. What that means is that, instead of an electronic filing cabinet where the Form 4 appears like the other documents on EDGAR and you can print it out or rekeyboard it into some other more useful form, you can actually identify individual pieces of data on the Form 4.

So for example, the date of the options grant is extractable automatically because it is in interactive data form. So is the date that the form was filed. And, by comparing those dates, you get an early read on where you should be focused. That is just one of many tools that can be used.

Because of the academic interest in this subject, our own economist's focus in this area, and the teams that we have working in both Corporation Finance and Enforcement, the analysis right now is getting pretty sophisticated.

Chairman SHELBY. Do you believe you have got the tools to do the job here?

Mr. COX. I think there is no question the analytical tools are there.

Chairman SHELBY. That is good.

Chairman Cox, as you noted in your testimony, the SEC is currently investigating approximately 100 companies for possible violations of the securities laws associated with the rewarding of stock options. What led to the decision to pursue these particular investigations? Beyond the cases in current active investigation, do you think there were other instances of backdating that occurred?

In other words, do we have 100 cases? Or is there a bottom line here with the number of companies involved? Or we just do not know yet?

Mr. COX. I think to answer that question it is worth asking what is the touchstone for SEC interest? We are interested in serious abuses. We are going to go after fraud. We are going to go after cases, for example, that might also interest the criminal authorities, as you have seen.

Chairman SHELBY. You are working with the Justice Department on a number of these cases, are you not?

Mr. COX. That is exactly right. We are not going to focus on the capillary. We are going to focus on the jugular. We are going to have an instinct, we hope, for the jugular here.

There are probably a lot of companies that have paperwork issues and inadvertent errors. The SEC is not going to use the force of its Enforcement Division to play gotcha in such instances. But we are very deeply and seriously concerned about serious intentional abuses. Those are the kinds of cases that we are going after.

So it has been that approach that has resulted in the selection of the cases that we are investigating thus far. If a company is under investigation, and then, it is established that the errors are inadvertent and that this is not a proper area for enforcement action, we will terminate our investigation, drop it, and move on.

Chairman SHELBY. Given the magnitude of the problem, would it be advisable at all for the Commission to urge all public companies to conduct an internal investigation? In other words, look inward, examining the timing and pricing of the options awarded in the past say 10 years or so?

In other words, to clean up their own act. I know it would be something the SEC would advocate.

Mr. COX. That is certainly good advice and is certainly best practice. Compensation committees and boards of directors, I am absolutely certain, are now on notice, and this hearing will help in that respect as well, that this is an area where they need to be involved.

Chairman SHELBY. But if they do not do this, we are going to probably see a small drip, here are some this week and next week and so forth, whereas a lot of public companies could probably help clean up the problem, could they not?

Mr. COX. There is no question. Our Division of Corporation Finance informs us that most large public companies, at least in America, have already gone through this process as a result of the attention that has recently been paid this issue.

Chairman SHELBY. Chairman Olson, I have a question for you, if I could. It has been suggested that auditors likely would have been more vigilant in their review of the timing and the pricing of stock option grants in the 1990's had the Financial Accounting Standards Board, FASB, expensing rule been adopted in the 1990's. Companies were then required to show the compensation cost of options on the income statement.

Do you have a view on that? I know it is reaching back.

Mr. OLSON. There is no question but what the issue of stock options dating was not considered a high priority risk exposure——

Chairman SHELBY. But it should have been.

Mr. OLSON [continuing]. At that time. And there are a number of other combinations of circumstances that perhaps would have brought it more into focus, and that may well have been one of them, if they would have been expensed as opposed to not had to be expensed under APB 25.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Cox, I want to refer back to Chairman Shelby's opening question to you about the failure on the part of a number of companies apparently to comply with the 2-day reporting requirement that was put in by Sarbanes-Oxley. Professors Heron and Lie, in a recent study, noted that the incidence of backdating was very substantially reduced as a result of the 2-day filing requirement, but that it remains significant for grants that are filed late.

Now as I understand your answer, you are now monitoring that situation; is that correct?

Mr. COX. That is exactly right.

Senator SARBANES. Do you have adequate staff to do that?

Mr. COX. As I mentioned, we have teams in two divisions working on this, as well as the assistance of the Office of the Chief Economist. And so we are, I think, all over this problem.

At the same time, I am quite certain that any additional resources that Congress provided would be put to good use.

[Laughter.]

Senator SARBANES. I hope you make that pitch to your appropriations committee. We will try to be helpful in that regard.

Chairman SHELBY. We are going to meet later today. I guess it will be about that, right, Mr. Chairman?

Senator SARBANES. I want to ask about spring-loading. The Los Angeles Times referred to two variations of a practice called spring-loading which I think has raised substantial public concern. It said, and I am now quoting them, "In this practice a company purposely schedules an option grant ahead of expected good news or delays it until after it discloses business setbacks that are likely to send the shares slower." So they can play it both ways.

The Commission actually has similar categories in its preamble to its new final rules on executive compensation. Chairman Cox, you were quoted in the L.A. Times as saying "Going forward we will be very interested in both kinds of spring-loading."

Now Chairman Olson, the PCAOB, in its Audit Practice Alert No. 1, in your footnote there you suggest that a grant of options, and I am now quoting you, “Immediately before the release of information that the issuer believed would be favorable to its share price, may create legal or reputational risks and raise concerns about the issuer’s control environment.”

Seems to me that you are raising a very important red flag here. What can be done about this practice?

I put the question to both of you.

Mr. OLSON. Senator, from an audit perspective, the reason to send the alert is that we would call attention to that exposure the same way that we would for any other contingent liability that a firm might have. It is intentionally in there to direct the attention to potential legal issues, but also reputational issues.

I think that the example that you just cited may, in fact, be as significant a reputational risk as a legal risk. But there are also income recognition, expense issues and tax issues that may result from the practice. And that was what we would expect the auditors to be looking for in instances where there is a timing question regarding the issuance of the options.

Senator SARBANES. Chairman Cox.

Mr. COX. As you note Senator, because spring-loading, as it is not legally but in parlance defined, refers to timing option grants to occur just before expected good news, it is bound up with concepts of insider trading. Whenever insiders in a company are conducting transactions in the company’s securities while in possession of material nonpublic information, these insider trading issues exist. And the category of cases that the Commission is going to be interested in are those in which insider trading can be established and has occurred.

But I think that we can dichotomize that category of cases, on the one hand, from the mere fact that options are being granted at a time that management processes inside information. Because management virtually at all times possesses inside information. So one has to look at the integrity of the options plans and the procedures by which the options are granted.

Senator SARBANES. Mr. Chairman, I see my time is up. Thank you very much.

Chairman SHELBY. Senator Bunning.

Senator BUNNING. Thank you Mr. Chairman.

Chairman Cox, this is just off the topic but I wanted to follow up on a question I asked you at a prior hearing. I asked about the status of the New York Stock Exchange’s application to expand their automated bond trading system. At that time, you said the Commission would be acting soon.

But nothing has happened yet. Can you give me an update on the status of its approval?

Mr. COX. I can. I would be pleased to do so. The Commission published the New York Stock Exchange exemptive request and a proposed exemptive order for public comment.

We have received comment letters in response. We are now going through that process of analyzing the comment letters and dealing with the New York Stock Exchange on these issues.

I do not see any philosophical questions. We are just working through the comments.

Senator BUNNING. Thank you very much. Let us go back to the current topic.

Should backdating be prohibited completely?

Mr. COX. That is entirely dependent on whether Congress has first defined what it means by backdating, since, at least under present circumstances, not only is backdating in some cases legal, but what we all think we agree on when we talk about backdating is ill-defined. It is not really defined in the law.

Senator BUNNING. That is the question. Should we define it?

Mr. COX. But if first we agreed on what it was we were talking about, and second we agreed that it was unethical, injurious to shareholders, violated our norms of disclosure and so on, then I think a statutory prohibition—although it might be belt and suspenders—would be completely in order. Because I think there is a universe of things we could all agree we mean to prohibit. And that is what these cases are all about.

But I hasten to add that these cases that we are bringing are brought on the basis of existing law. So there is law there to go after this.

Senator BUNNING. This gets a lot to the point better I guess, this question. What do you think is the appropriate role for Government in regulating how companies compensate employees? Should Government's role be limited to requiring disclosure so the market can determine what compensation is appropriate? Or should we be doing more and regulate how business can and cannot compensate their employees?

Mr. COX. Provided that there is no lying, cheating or stealing going on, then, certainly from the standpoint of the SEC's traditional role and authorities, disclosure is by far the preferred course. Where companies are operating in a market environment, certainly there is a competitive market for talent. And so the executive compensation arena as a market, like anything else, should be free to conduct themselves as market actors without Government anticipatorily or preemptively micromanaging that process.

But, as we discuss options backdating here today, it is also possible that the normal task of a company paying someone who works for them can be perverted or manipulated into a device or a scheme to rip off the shareholders. And I think we have to be on our guard against that.

Senator BUNNING. In Mr. Lie's testimony today he advocates reporting options grants on the same day they are granted. This is for both of you.

Would it be feasible for companies to file with the SEC on the same day that options are granted?

Mr. COX. That is a very important question and I do not know the answer. I do not know the answer despite the fact that I have asked that question myself. It is something that we are trying to look at and understand.

With companies that have operations around the world, the time change becomes an issue. You have to be able to, if you are in Europe, call somebody in the United States if the transaction takes place in that way. There are just a lot of aspects of this that may

make it a little more difficult than it seems to reduce the period from 2 days to one. The 2-day period is already causing some people some problems.

Senator BUNNING. Go ahead.

Mr. OLSON. Senator, I would tend to support the comments of Chairman Cox. I think the important thing is that where previously it had been 45 days after the close of the fiscal year, that allowed for a lot of opportunity for mischief where the 2-day window narrows it down very significantly. And when you combine the combination of down to 2 days with now the full implementation of FAS123R, I think you have significantly eliminated a lot of the abuses.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Senator SARBANES. Senator Menendez, would you yield me 10 seconds just to make a comment?

Senator MENENDEZ. I would be happy to.

Senator SARBANES. It follows right in.

The one problem I see with this full disclosure as serving the remedial requirement is it presupposes the shareholder access to the Board of Directors in order to make them accountable that does not exist in many instances.

Now the Commission has taken up that issue in the past. I think you have now put it off. But I just wanted to make that observation.

In other words, you can get the information. Then what are they in a position to do with it? Other than if you do not like it, sell your stock and go off in another direction.

But in terms of correcting the corporate practices, it is very much related to what the shareholders can do in terms of changing the corporate governance, either the directors or the management. That is a different issue but I just wanted to make that observation.

Mr. COX. But I think it is a very important issue. The fact is we do not yet have experience with a combination of the Sarbanes-Oxley disclosure requirements that, as Chairman Olson just mentioned, foreshortened the period from sometimes over a year that you had to report these grants down to 2 days, and what the SEC is now putting in place, much more detailed disclosure about not only when grants are made and the terms of those grants, but the policy of the company.

Do you use timing as an element in determining how you grant options? And so on.

Because none of this disclosure has ever been made before, perforce it is difficult to know how the market will react to that kind of information and whether it will be an effective tool. But I certainly expect it will help. And the question is will it be the entirety of the solution or not?

Senator MENENDEZ. Mr. Chairman, we have had an antiseptic discussion about this topic. I would like to try to have you characterize it for us.

I read your whole statement, in addition to listening to your oral testimony. What do you believe is the--how would you characterize this issue? A serious one? A major one?

Mr. COX. There is no question that it is serious. There is no question that it is major. And it is certainly major for the companies involved and for their shareholders.

Our intention going forward is to cabin off this problem, to ensure that it is an historical anomaly and that it does not persist. So we are giving registrants every opportunity to understand going forward how to avoid these problems. And we are coming down hard on the most serious abuses that have taken place.

Senator MENENDEZ. Because it is not only the number of investigations, I heard the figure 120, but it is what the dollars that may be affected in that process.

I am referring to this Wall Street Journal article that had a listing of all of these different companies. And just to take two that had dollar figures attached to it, in one case there was an acknowledgment that, in fact, they may have to reduce the past 3 years net earnings by $286 million.

In another case the company said that it expects to record additional non-cash stock-based compensation expenses of more than $750 million as it corrects accounting for past stock option grants. That is a total, just for those two companies, that's $1 billion in restatement.

And so it seems to me that there is potentially a very fair amount of money that is involved as it relates to shareholders at the end of the day. So I appreciate hearing that you believe it is both major and serious.

You said you had the analytical tools, in response to the Chairman's question. Are there any other tools that you need that you do not have to vigorously pursue the investigation of these companies?

Mr. COX. I do not believe so, although there are always opportunity costs. We have chosen to focus resources on this area. So, to the extent that a focus in one area creates an opportunity cost elsewhere, we are probably paying such an opportunity cost.

Senator MENENDEZ. Sometimes board of director members get stock options, as well; is that not correct?

Mr. COX. Yes, of course.

Senator MENENDEZ. In the process of doing that, are you not concerned with the potential conflicts of interest and overlapping relationships that could exist on the special committees that many companies have, as part of their internal investigation into the backdating of stock options?

Mr. COX. Yes, of course, conflicts of interest have to be a concern, not only of the SEC but of all regulators and certainly of investors. The SEC, for its part, mandates very full disclosure. And, as I described, we mandate much more in this respect now than we have ever had before, effective with the next proxy season.

Senator MENENDEZ. Mr. Chairman, my last question.

Restatement, that simply does not absolve you if you had an intentional effort to violate the law, I would assume? Because it would be the equivalent of going ahead, robbing the bank, somebody finding out that you robbed it, and then returning the money.

Mr. COX. That is correct. And in many cases we see both fraud convictions in a criminal sense and fraud judgments in a civil sense accompanied by restatements, which are necessary to clean up after the damage is done.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Allard.

Senator ALLARD. I am gathering from your testimony so far that you think you pretty much have the tools, it is just pretty much enforcement is the challenge you have. You need to have the resources for that enforcement. Is that correct?

Mr. COX. I think that is right. There are two aspects to this problem. One is looking back at what went on. I think we have all discussed here some of the historical reasons that these problems could exist. There was perhaps a perfect storm of circumstances that enabled these opportunities for fraud and manipulation.

So we have got the historical problem on the one hand and enforcement is going after these cases.

Then we have the question of what happens now? And what happens in the future? The SEC is using its regulatory powers to issue both rules and guidance in this area so that hopefully for all but the most nefarious of wrongdoers there will be every opportunity to avoid these problems in the future.

Senator ALLARD. That kind of brings me up into my next question. Have you done some analysis on what the motives are of the companies? Part of it was maybe driven by the tax code? Was it ignorance of the law, not realizing that they could not do that procedure? Maybe it is a company that had just become public and they did not have to worry about that when they were a closely held corporation?

Or was it some—maybe they were purposefully trying to instigate some fraud? What was driving the motives? It would be nice if we had a list of what motivated companies to do this.

Mr. COX. Of course. I mentioned in my formal testimony that you should expect reasonably soon additional guidance from the Office of the Chief Accountant at the SEC on the accounting issues connected to abusive backdating. One of the reasons that we did not rush out with guidance—although issuing it as quickly as we can—is that the SEC, and the Chief Accountant, wanted to make sure that we had our arms around all of the different fact patterns. And I think while there are perhaps endless variations on these themes, we are reasonably comfortable now that we have seen the major variations and that we understand the different fact patterns.

In some cases people have black hearts. In other cases, they are pure as the driven snow and they made mistakes and it was all an accident. And then there is everything in between. The fundamental economic motive for backdating, of course, is that you get the opportunity to take money from the shareholders and give it to someone else without anyone knowing. And you do not pay taxes on it. And you do not disclose it as an expense in your financial statements. Those are all illegitimate objectives, but they are also the payback from violating the law.

Senator ALLARD. On some of these cases where——

Mr. COX. If you get away with it, I should say, which we intend for people not to do.

Senator ALLARD. Were some of these, in cases of fraud, were they pretty elaborate schemes and difficult to pick up? Or were they pretty straightforward from an accounting perspective? Maybe Chairman Olson would be the best one to answer that question.

Mr. COX. I can only describe, of course, the cases that we have publicly brought, but I think that they serve as a good example. I have described there in my formal testimony, which is abridged in my oral statement; it is much longer in the written form. But I have described the facts of those cases. And I think you will see that these are not casual acts. These are very elaborate schemes carried out quite knowingly, the SEC alleges, by the people whom we have charged.

Senator ALLARD. Chairman Olson, do you want to comment?

Mr. OLSON. Senator, there is a process by which an illegal act, when an auditor encountered it, would either be referred up through the chain of management to the board, to senior management, or ultimately even possibly to the SEC.

But our focus from an audit perspective has been instead to look at the environment that would tend to create these kinds of risk exposures.

For example, if you have a company that is an aggressive issuer of options, in an industry where there is a great deal of volatility of that stock, and they continued to use the accounting treatment, APB 25 accounting treatment, up to the last possible minute, that would be evidence to an auditor that they might want to look much more carefully at whether or not there were timing issues with respect to the audit.

So, rather than try to look at it from the legal perspective, we look at it from where the accounting risk exposures are.

Senator ALLARD. You mentioned that we have not really defined the backdated option. I think you mentioned that.

What is the problem of defining the backdated option?

Mr. COX. I do not think it is intractable. I think we can define it if we chose to do so. It would just be a necessary first step if there were going to be any specific rulemaking or legislation on this topic.

And so, in answer to Senator Bunning's question, I just wanted to make sure that we all understood that backdating thus far is not defined in the law but we are able to use pre-existing legal concepts without difficulty in these cases.

Senator ALLARD. So it has been done through court case pretty much? You do not think—you have not defined it in regulatory—or if you do decide to do it in regulatory—do you need law to be able to——

Mr. COX. I think this is really esthetics. The question is whether or not you would feel better if the term backdating had a legal definition. But all of the elements of backdating that make it abusive and illegal backdating are clearly defined in the law right now. So I do not think we have any trouble bringing these cases.

Senator ALLARD. Thank you. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Carper.

Senator CARPER. Gentlemen, welcome. I just walked in. I missed your testimony.

Let me just start off, if I could, asking a question of you, Chairman Cox.

You have a reputation being plainspoken so I will just ask you to use that reputation in responding.

What do we need to be doing in this regard to address some of the behavior that we have become aware of? What do we need to do in this Committee and in the Congress, if anything?

Mr. COX. First, this oversight hearing is helpful because we have two problems. One is an historical problem, the things that already have happened and gone by the boards. The other is what happens today and going forward.

I believe that the attention that is being paid in the regulated community to this backdating problem is, in major respect, a function of the attention that has been paid to it by the Congress and by the Agency. So first, keep a focus on it.

Second, I think the approach that I have inferred the Committee taking today is the right one, which is keep a weather eye to the question of whether our existing laws work. So far our experience at the Agency is that they do, and that they are adequate to this task. So we are not here today asking for new legislation. But watch it like a hawk to make sure that we do not miss an opportunity if one arises.

Senator CARPER. I think you have been asked if you have the tools that you need. Is that correct? And you said you do?

Mr. COX. We do. We have chosen to apply the Agency's resources particularly in this area. I mentioned that because we are an agency with finite resources that implies an opportunity cost. And that to the extent—within reason, to the extent Congress chose to provide the SEC more resources, I think we would put them to good use. But we have the resources and are applying them to deal with this problem right now.

Senator CARPER. Good, thanks.

Mr. Chairman, Chairman Olson, the same two questions. What ought we to be doing now here in this Committee and in the Senate? And do you have the resources that you need?

Mr. OLSON. Senator, as we had discussed earlier, there is an extent to which this is an issue that the opportunity for abuse is significantly behind us. But nonetheless, there are still audit issues.

As we think of the issue prospectively, we would expect that accounting firms would have, or the auditors would have, a risk measurement or some sort of a risk focus that would help them identify what the future issues will be. Options dating is the issue du jour but there will be others, as you know.

So what we are interested in doing is seeing that the accounting profession is aware and is alert to those and has the tools to deal with those. And so I think that is the case.

Regarding resources, we are getting there. We are a startup, as you know. You gave us a big challenge, the Congress did, when it was started. I think that my predecessors, who I am very proud of, have done a very good job of getting us significantly up to speed, but we are getting there.

Senator CARPER. Good. Thank you.

My other question relates to investor confidence. The economy is, we are in a point where we are seeing a leveling off in home sales,

home prices, some concerns about what is going to happen to interest rates and inflation. And the last thing we need is for investors to be spooked. We want them to continue to have strong confidence in our markets.

As this issue of backdating of stock options gains some public profile, any sense for how it might be affecting investor confidence?

Mr. COX. I suppose the good news here is that virtually at the same time that the public learned about the problem of options backdating, they could see their Government in action going after these problems. They can also see that there are already rules in place and now effective that will make much more elaborate the disclosure in this area. They also can see that the opportunities for backdating that existed have been foreclosed. So that now it will require truly aggressive cheating and stealing in order to carry this out. The easy opportunities are gone.

I would hope, therefore, that this would not be an issue of investor confidence for that reason. Or indeed that investors would have confidence that the system is working the way it should in terms of law enforcement. Certainly the SEC, as the investor's advocate, sees our main mission to protect America's savings and investment. And so we want to be sure that people see their government working.

Senator CARPER. Thanks. Thanks.

Mr. Chairman, Chairman Olson, do you want to add or take away anything from that?

Mr. OLSON. Only to this extent. For reasons that we have discussed earlier, you readily identify the type of company that were involved in the most aggressive use of stock options. And I think it will be interesting to see the extent to which the market responds in some ways, either those companies or that group of companies. I think it is the disclosure of some of these practices that will help bring about a better awareness, to separate the people that disclose in a way so that they do not obfuscate the substance of the transactions but clearly state them.

The market, in a perfect world, would reward those companies relative to the others.

Senator CARPER. Thank you both.

I would ask you both to continue being vigilant in going after the perpetrators of these schemes. Thanks.

Chairman SHELBY. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman.

Chairman Cox, as you know, another Senate Committee, the Finance Committee, at this very same time, is holding a hearing on executive compensation as well to look at the issue from the perspective of the tax code. Both in your oral testimony and your written testimony you have raised issues in that context.

In your written testimony, you state "Beyond the obvious fact that the income tax code discriminates in favor of non-salary compensation that can be taxed as capital gains, one of the most significant reason that non-salary forms of compensation have ballooned since the early 1990's is the $1 million legislative cap on salaries for certain top public company executives that was added to the Internal Revenue Code in 1993." And then you went on in

both places to say this law change deserves a place in the museum of unintended consequences.

Could you comment for a minute about whether you believe that Congress should act now with regard to that $1 million cap? And also, could you address generally the question of the fact that the compensation on stock options is taxed at a capital gains tax rate, though it is not a normal investment decision that is being made, but it is a tool utilizing stock as an executive compensation tool. Should we look at the question of the level of taxation or the type of taxation or tax treatment as we address this issue?

Mr. COX. I am sorely tempted to tell you what I think the tax laws ought to look like, because I got paid to——

Senator CRAPO. That is the invitation here.

Mr. COX [continuing]. Engage in those debates for many years. But I think you probably want me to give you the SEC's perspective on it, and you invited me here as the Chairman of the SEC for that reason, and not as a former member. So let me restrict myself to the SEC's interest in this question, which is that we have an abiding interest and we are very, very determined to succeed in this area, in making executive compensation understandable to the shareholders. We are in the business of transparency and clarity.

So, to the extent that the tax code causes companies to do something that otherwise they would not do, that is more complicated in the area of executive compensation than what the market would produce. That is, one would hope, an unintended consequences, and it makes our mission more difficult.

To simplify what we have in, I believe it is Section 162(m), we have a million-dollar price control that has proven unworkable. It is an unworkable price control and its repeal would actually encourage companies to subject more of the CEO's compensation to taxation at ordinary income rates.

Senator CRAPO. Thank you.

Chairman Olson, do you have an opinion on this issue?

Mr. OLSON. Just to remind everybody of a fundamental truism, I guess, that any tax penalties or tax incentives have consequences. They tend to work. And while there was an unintended consequence to this tax provision perhaps what should have been clear is that there would have been a response to it in one way or another. What was unpredictable was the manner in which the response would play out.

The fact that there was a response should have been predictable.

Senator CRAPO. Thank you.

Chairman Cox, I will reserve to our private conversations your personal opinions about the tax code, but I would like to know what they are.

Mr. COX. They are voluminous, just as is the tax code itself.

[Laughter.]

Senator CRAPO. Thank you, very much.

Chairman SHELBY. Thank you, Senator Crapo.

Chairman Cox, Chairman Olson, we appreciate your appearance and I am sure you will be back. Thank you very much.

But more than that, I appreciate your diligence in following this issue.

Senator SARBANES. Mr. Chairman, as our witnesses depart, I just want to bring to Chairman Olson's attention an article that was in the Wall Street Journal back in June, entitled "Backdating woes beg the question of auditors' role." The article began where were the auditors?

So I would commend that article to you.

Mr. OLSON. I am quite familiar with the article and we continue to ask that question of the profession and of ourselves. Thank you.

Senator SARBANES. Thank you.

Chairman SHELBY. Thank you both very much.

We will call up our second panel, Mr. Lynn Turner, Managing Director of Research, Glass Lewis and Company, and former SEC Chief Accountant; Dr. Erik Lie, Associate Professor of Finance, University of Iowa; Mr. Kurt Schacht, Managing Director, CFA Centre for Financial Market Integrity; and Mr. Russell Read, Chief Investment Officer, California Public Employees' Retirement System.

Gentlemen, we appreciate your appearance today.

As I said earlier, your written testimony will be made part of this hearing record in its entirety.

Mr. Turner, we will start with you. As I said earlier, all of your written testimony will be made part of the hearing record.

We are going to have a vote in about 30 minutes, we think. So we would like for you to get to your points. I think all of you have got something to say here today and we appreciate that.

STATEMENT OF LYNN TURNER, MANAGING DIRECTOR OF RESEARCH, GLASS LEWIS & CO., LLC.

Mr. TURNER. Thank you, Chairman Shelby, ranking member Sarbanes.

This is an important issue and I congratulate and commend you both on holding this important hearing. It is also worth noting, I think though, Chairman Shelby, I remember in the last couple of years we went through quite a battle over options and the expensing of options. At the time I was spending a fair amount of time in the tech community.

Chairman SHELBY. We all have a little shrapnel in us, but we are still standing.

Mr. TURNER. Yes, indeed. And we would not be standing, though, without your leadership.

Chairman SHELBY. Thank you. Senator Sarbanes was also standing with me on that issue.

Mr. TURNER. I think you both took bullets. You look better for the wear and tear.

But moving on, I would like to focus my remarks to start with just on spring-loading. I know some people have said spring-loading is not illegal. The notion of, as Chairman Cox said, granting the options and then right thereafter disclosing the good news, realizing that the options were discounted because of that.

I could not disagree more with those who have said that that is not a problem and is not illegal. As we have gone through filings, we have yet to see a filing that has properly made those disclosures. We often heard well, it is not illegal if. But we have never seen the if. The disclosures have been grossly false and misleading,

saying that they were granted at the market price when they were not; they are properly valued when they were not; the financial reporting was in compliance with GAAP, which it was not. And they failed to note the negative tax consequences, which the other Senate Committee is holding their hearing on today.

So in summary, I think the investors were misled and the executives failed to tell the truth, the whole truth and nothing but the truth, which is a violation of the securities laws. So I think those are definitely a problem.

The question was actually brought up earlier, too, about the benefits of SOX and how SOX, in a number of areas has certainly helped here, the timely filings, the internal control provisions, the executive certifications. But if you look at the written testimony that I submitted, you will see in there the Forms 4 in just this last year.

So current people were asking is this still going on? And the answer is yes it is, as Professor Lie's paper noted. But if you look at the Form 4s that are included in the testimony for Children's Place, you will see examples, actually several examples, of a situation where well after the 2-day requirement the forms were filed, well after the transaction date. And right after the transaction date the company came out with a positive announcement and the stock price jumped over 26 percent.

So this is in 2005. This is not 2002, 2001. It is still going on. The late filings of these forms continue. We have noted a number in the written testimony that we see and we have actually seen some others on top of that that is not disclosed in the testimony.

The result of this is the list that is in the testimony, we started with a list of 121 companies when I first was asked to testify. It is now up to 128 and the drip, drip, drip Chinese torture that you mentioned that investors are facing continues.

I have no doubt that we have not yet gotten to the bottom of it. I was heartened to hear Christopher Cox, Chairman Cox, say that in fact the SEC would commend companies to go out and do self-investigation and self-reporting on this. I do not think the SEC, in any way, has the resources to get to the bottom of it.

Certainly, it is my understanding the SEC——

Chairman SHELBY. They do have the resources to set some examples, do they not?

Mr. TURNER. Yes. Yes. They really do need to bring some great cases. They have brought a couple. But keep in mind you have 128 under investigation now. You have got two cases filed so far.

There can be a couple of lessons. One, a lesson if you really do make a good case. But if at the end of the day there is only two out of 128, that also sends a very strong message too, that most are not going to have to worry about it. So that is a concern, especially given the number of companies that, as a result of this thing, are restating, have turned up with internal control weaknesses, have had to provide late disclosures.

The question was asked earlier also about where were the gatekeepers? And I think there are some legitimate questions with respect to the auditors. But I think the lead gatekeeper here is the legal counsel. I have sat on ports. I have granted options. I have received options. I have used them in small and big businesses.

And the one person, the one gatekeeper that is always there is the legal counsel.

And so I think we are going to find, as in one of the cases we have already seen, the legal counsel is the gatekeeper who is most problematic here. And certainly I hope the SEC will do something with that.

I think the No. 1 thing that does need to be done here is stricter enforcement by both the SEC and the PCAOB. The SEC staff need to get an electronic tool that automatically allows them to go into the filings. You can see the filing right there. They should have an electronic tool that, without adding staffing, automatically kicks out for them those findings that are late and outside the 2 days, such that they could automatically send a dunner notice, something like that.

Chairman SHELBY. Do they have the software today to do that, in your judgment? Do you know?

Mr. TURNER. No. No, they do not. I have spent some time with the staff on a number of their electronic tools. The SEC, certainly when I was there, was in the dinosaur age. I think they have come a fair amount of distance since then. If you look at their most recent annual report, they say they are pilot testing a lot of tools. The reason they are pilot testing is they do not have the resources to buy them.

Congress has got to give them the resources to buy tools and to do the type of electronic monitoring that I just described. You cannot go through all of these filings. There is thousand upon thousands upon thousands of filings coming through on it. They do not have the staff to go through each of those manually. You could do it fairly quickly automatically, electronically. They deserve to have those tools if you want them to do the job that they have been asked to turn around.

Chairman SHELBY. Do you have any judgment as to the kind of money you are talking about? I think the results would be good.

Mr. TURNER. I do not think the type of money that you are talking about is a whole lot of money. In fact, we are putting in a similar system for ourselves. You can tee it off. But you are not talking hundreds of millions of dollars here.

On the other hand, you see corporations, quite frankly, invest $10 million or $15 million a year in technology, and it is not happening and it needs to happen.

I would also note that——

Chairman SHELBY. I was asking that question because in another committee I chair that Appropriations Committee and I am going to talk to Chairman Cox this afternoon about that. Senator Sarbanes asked him do you need more resources. I have asked him that, too, because I agree with you. And you know, as the former Chief Accountant, we have the obligation, I believe, to furnish the resources to the SEC to do their job. If they need more technical resources in today's world to help them do this, that is our obligation.

Mr. TURNER. I could not agree more with you, Chairman Shelby.

Let me, just a couple of things to close off here so we can move along.

You were brilliant in your defense of the FASB and the independent private standard setting. That will only work though if that standard is appropriately implemented. I am concerned about whether that is going to occur. There has already been some research that indicates that people are playing games with that number. That number is a key anchor part of the new FCC disclosures that Chairman Cox talked about, the value of these options.

If people are allowed to play games with that——

Chairman SHELBY. Elaborate what you mean by that, for the record. This is important.

Mr. TURNER. There are some key points of data that go into these models that calculate the value of these options, primarily the volatility rate, how the stock is moving up and down over time, as well as the expected life of those options. And by decreasing the volatility and decreasing the expected life of the option, you can have a fairly dramatic impact on the value of the option and the compensation expense that is being recorded.

We have seen instances where companies will change volatility say from a 70 percent down to a 30 percent level without seemingly a change in the actual volatility of the stock in support for that. Likewise with the lives.

If that goes on and that becomes the practice, then we will have lost a significant benefit from that standard that people went through such a battle over. And so I would certainly hope that the Committee would encourage the SEC to ensure that they watch that, we get good implementation of that standard.

On the board level, I would just say boards do need to get much more actively involved, which they do in the U.K. It is feasible to file on the same days you do the grant. They do it in the U.K. I have a tough time believing our English counterparts can do it and are better at it than we are, so I think we could get it done in a day here, as well.

I would also urge the SEC, Chairman Cox, though to go out and urge all companies to self-report and self-investigate. The Council for Institutional Investors has written 1,500 letters to 1,500 of the larger corporations in the United States asking them about their backdating, where they had practice, where they have done it, what their policy is. To date they have only received 200 letters back. There are 1,300 unanswered letters out there which, without a doubt, means there is still a serious question out there.

So I think with that, let me close it off and just say I do think it is an issue. I commend the Committee for having the hearing. I think the hearing will do a lot to bring attention to this matter in the boardroom and elsewhere. So thank you.

Chairman SHELBY. Dr. Lie, we appreciate the work you have done over the years and we want you to keep it up. And we appreciate your appearance here today. You can sum up what you want to tell us.

STATEMENT OF ERIK LIE, ASSOCIATE PROFESSOR OF FINANCE, UNIVERSITY OF IOWA

Mr. LIE. Thank you, Chairman Shelby, ranking member Sarbanes, and members of the Committee. Thank you for inviting me to testify today about stock option backdating.

We have been talking quite a bit about stock options and stock option grants already, but let me provide some key aspects about this process.

Stock options are granted to executives at various intervals. It is common to grant options once a year, though it is also possible for executives not to be granted options in a year or to be granted options numerous times in a year.

In most cases, there is no fix schedule to these grants, meaning that they do not occur on the same date in consecutive years.

The new 2-day filing requirement which we talked about earlier dramatically reduced a lag between the grant date and the filing date. You will see in my written report a graph of this. Importantly, though, about 22 percent of grants since August 29, 2002 were filed late and almost 10 percent were filed at least 1 month late.

Most executive stock options are granted at-the-money, that is the exercise price is set to equal stock price on the day of the grant. In a sample of about 40,000 grants from 1996 to 2005, the exercise price matches the closing price on the grant date in 50 percent of the cases. And interestingly, it matches the closing price on the day before the grant date in 12 percent of the cases.

The practice of granting options at-the-money provides incentive to time the grant to occur on a day when the stock price is particularly low or to manipulate the information flow around the grant date. Note that these incentives would be present for in-the-money and out-of-the-money grants also, provided that the exercise price is a function of the stock price.

In my 2005 study entitled "On the timing of CEO stock options awards" I documented negative abnormal stock returns before and positive returns after CEO option grants between 1992 and 2002. These trends intensified over time. I further reported that the portion of the stock returns that is predicted by the overall market factors exhibits a similar pattern, prompting my conclusion that, unless executives have an informational advantage that allows them to develop superior forecasts regarding the future stock market movements that drive these predicted returns, the results suggest that the official grant date must have been set retroactively.

In a soon-to-be-published study entitled "Does backdating explain the stock price pattern around executive stock option grants?" that I coauthored with Randy Heron of Indiana University, we found further evidence in support of my earlier backdating argument. As noted earlier, a provision in the Sarbanes-Oxley Act reduces the SEC filing requirement for option grants to 2 days. To the extent that companies comply with this new requirement, backdating should be greatly curbed.

Thus, if backdating explains the stock price pattern around the option grants, the price pattern should diminish following the new requirements. Indeed, we found that the stock price pattern is much weaker since the new reporting requirements took effect.

Any remaining pattern is concentrated on a couple of days between the reported grant date and the filing date, and for longer periods for the minority of grants that violate the 2-day reporting requirements. We interpret this as strong evidence in support of backdating.

In an unpublished study entitled “What fraction of stock option grants to top executives have been backdated or manipulated?” also coauthored with Randy Heron, we used a sample of almost 40,000 grants to top executives across about 8,000 companies between 1996 and 2005 and we estimate the following: 14 percent of all grants to top executives dated between 1996 and 2005 were backdated or otherwise manipulated.

Twenty-three percent of unscheduled at-the-money grants to top executives dated between 1996 and August 2002 were backdated or otherwise manipulated. This fraction was cut to less than half, to about 10 percent, as a result of the new 2-day reporting requirement that took effect in August 2002.

Among the minority of unscheduled at-the-money grants after August 2002 that were filed late, 20 percent were backdated or otherwise manipulated.

Among the majority of unscheduled at-the-money grants after August 2002 that were filed on time 7 percent were backdated or otherwise manipulated.

Backdating was also found to be more common among tech firms, small and medium firms, and firms with a high stock price volatility.

The auditing firm is only modestly associated with the incidence of backdating.

And finally, 29 percent of firms that granted options to top executives between 1996 and 2005 manipulated one or more of these grants in some fashion.

So clearly, backdating of option grants was a pervasive practice among publicly traded corporations in the U.S. in the late 1990’s and the beginning of this century. My own research suggests that spring-loading, bullet-dodging, and manipulation of the information flow was either significantly less prevalent or less successful in the aggregate in producing immediate gains for the option recipients during the same period.

The problem of backdating can be eliminated by requiring grants to be filed electronically with the SEC on the same day that they are granted. Of course, this requirement has to be strictly enforced with appropriate penalties for any violation such that the frequency of late filings that is evident for the last few years is greatly reduced.

As the problem of backdating is eliminated, the problems of spring-loading, bullet-dodging and manipulation of the information flow might become more prominent. Thus, it is critical to clarify whether these alternative strategies are legal. And if so, restrictions to minimize their occurrence should be developed. In particular, options should not be granted near major corporate announcements. And further, there should be timely and complete disclosure of these grants.

Finally, to eliminate timing relative to recent stock prices, the benchmark stock price should be the price on the grant date. For example, if the options are granted at-the-money, the exercise price should be set equal to the stock price on the same date, on the grant date, and not the stock price on the prior date, which is fairly common practice, as I indicated earlier. This eliminates the possibility that options are granted on a day when the price has in-

creased significantly but the prior day's lower price is used for contracting purposes.

Thank you.

Chairman SHELBY. Mr. Schacht.

STATEMENT OF KURT SCHACHT, MANAGING DIRECTOR, CFA CENTRE FOR FINANCIAL MARKET INTEGRITY

Mr. SCHACHT. Good morning, or good afternoon at this point. Thank you very much for inviting us to be here. I am Kurt Schacht from the CFA Centre for Financial Market Integrity, which is the advocacy arm of the CFI Institute, and we are the credentialing organization for the Chartered Financial Analyst designation.

Thank you, Senator Sarbanes and Senator Shelby, for inviting us, and also for holding the line on 123R. I know a lot of investors very much appreciate that, as we do.

So again, thank you for the opportunity to be here.

We were asked to provide some perspective of our organization on options backdating and some of the accounting and auditing issues associated with that. And we come to this topic primarily as an investor advocate and, as we have mentioned here before, with a focus on protecting shareholder interests and ensuring accurate and transparent financial reporting.

We were one of the early voices to the SEC to amend the newly released executive compensation disclosures to include a more direct focus on the issues of backdating and the companion practice of spring-loading. Chairman Cox and the SEC have done a very fine job, in our view, with those new rules.

Our perspective is this: historically, the rationale for granting stock options was alignment of shareholder interests and providing a performance incentive. There are a number of commentators out there today that are suggesting that backdating and spring-loading were really not manipulation, intentional manipulation of information or of the option price, that backdating does not necessarily pervert the incentive purpose of options, that backdated options continue to have those attributes of alignment and incentive, and that if backdating is a misdeed or it is a crime, that it is a victimless one.

We think, obviously, that those views are quite misguided. Options reward performance. They should not reward the manipulation of the grant process.

We do very shortly agree with Senator Allard and others who have talked about the benefits of options. We agreed that discounted options and stock are an entirely permissible executive compensation tool. But to achieve the discount through sleight of hand and then, in the case of backdating, to conceal that activity by inaccurate financial reporting and tax filings is clearly not in alignment with shareholders' interests and it does place the company itself at substantial risk of manager removal and uncertainty, huge investigative and regulatory costs, and that is hardly a victimless infraction, in our view.

We remain very concerned about the ultimate scope of the backdating cleanup problem. Backdating itself is a thing of the past, no pun intended. It has been done in by a number of the things that Chairman Cox has mentioned here this morning. But the degree of

the necessary cleanup due to the vast numbers of companies that have engaged in option granting practices, as well as the size of some of these grants in that time period from 1990 through 2002, is still an unknown aspect of this controversy. And I think we need to get our hands around that. As Senator Menendez remarked, this should not become a sequel to the financial reporting crisis in confidence that we experienced earlier in this decade.

Now with respect to auditing and accounting practice, very quickly the auditing standard relating to stock option expenses that existed for many years before the current day, 123R, was very clear on this. APB opinion 25 required that in-the-money option grants require the reporting of the relative compensation expense unless it is immaterial. The entire premise, the entire premise of backdating was to get an in-the-money grant. So nearly every company that has been identified as having backdating problems has failed to properly record the compensation expense and, as a result, has failed to file financial statements that comply with generally accepted accounting principles. The rules on backdating were clear and they were not subject to interpretation.

Viewing the backdating issue from the internal auditor perspective still concerns us very greatly. How was this practice repeatedly missed or even, in some cases, possibly sanctioned? In some cases, it may have been sloppiness or incompetence. It may have been a matter of an intentional act of concealment by the company's management.

Either way the internal papering of the option transaction appeared as though no compensation expense needed to be reported. The auditors felt that that was a very low-risk noncash area for review. They relied on the company records and they did not verify what had actually happened.

It is one thing to be lied to by your client. It is quite another to be complicit in the deceit. And we remain concerned whether certain auditors were actually complicit, turning a blind eye to this practice, given the client pressures that were so evident back in the days of option megagrants and because it seemed like everyone was doing this in certain sectors of corporate America.

No matter which it is, we now would expect that proper audit procedures would demand a very close look and a verification of these option restricted stock practices.

A couple of real quick lingering concerns, the gaming of grants of both options and restricted stock around the release of material nonpublic information, or spring-loading, needs to have another look. The SEC, as Chairman Cox mentioned, requires now that there be a full review and report of issues by the compensation committee. But it does not prohibit spring-loading. I think we need to ask the question should the officers and directors who are in control of the material nonpublic information, and also in control of the option granting process, whether they should be barred from participating in any spring-loaded grants, just as they would be prohibited from trading in any of the company's securities while in possession of that information.

Finally, one facilitator of backdating was accounting rules that failed to result in fair value expensing of the cost of all options. 123R has now resolved much of that. But historically auditors ap-

parently failed to consider such off-balance sheet items of sufficient high risk to warrant a full audit or a full review.

There are many more items, several of considerable size, relative to most company's balance sheets that remain off balance sheet and that remain unexpensed. If they are reported at all, they are reported in the company's footnotes. I think the lessons of Enron and now the lesson of backdating are pretty clear, that auditors should tighten their procedures to make certain that these off-balance sheet items receive similar attention.

I would conclude by saying that backdating may be effectively stopped at this point, but to keep the pressure on companies to come clean so that this does not become a Chinese water torture situation, and that we sanction past infractions appropriately. We should consider whether and who should be engaged in the process of spring-loading. We should confirm whether any of these manipulative practices have carried over to the restricted stock area. And finally, we should encourage audit procedures that guard against this misreporting of similar off-balance sheet items.

Thank you very much.

Chairman SHELBY. Thank you, sir. Mr. Read.

STATEMENT OF RUSSELL READ, CHIEF INVESTMENT OFFICER, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Mr. READ. Thank you, Chairman Shelby, Senator Sarbanes, and other members of the Committee.

I am pleased to be here today to provide an institutional investors' perspective on option backdating and spring-loading. I am Russell Read, Chief Investment Officer for the California Public Employees' Retirement System or CalPERS. As you know, CalPERS is the nation's largest public pension system with more than $209 billion in assets.

We have been long a voice for good corporate governance. We are committed to executive compensation reform, full disclosure and transparency of pertinent financial information and director accountability. The recent allegations around secret and even fraudulent backdating of options are disturbing. We appreciate your leadership, Mr. Chairman, in calling for this hearing and for your personal commitment and the commitment of the Committee toward addressing this problem.

CalPERS believes that as part of a good executive compensation policy, stock options are appropriate.

As referred to by Mr. Schacht earlier, the core alignment of interest principle for responsible use of options can be framed as a question. Namely, do the options align employee interests with that of share owners? Moreover, do boards and compensation committees fully accept the alignment of interest principle with respect to option grants?

The widespread prevalence of backdating potentially indicates that boards and compensation committees have not fully accepted the alignment of interest principle with respect to option grants. And when critical features of the options are hidden from view, and when the options awards themselves did not tie to performance, it can create a serious problem.

As you know, CalPERS's size does not lend itself to selling our stocks in troubled companies. In effect, we are a source of long-term, indeed permanent investment, in the U.S. capital markets. When an executive takes stealth payments that we cannot trace, when companies make false statements and omit material facts concerning backdating of option grants, billions of dollars can be inappropriately shifted from share owners to key employees. And once the truth of such option grant practices are made, it can cause company stocks to fall precipitously. This directly hurts the retirement security of ordinary Americans.

In CalPERS's case, we are talking about clerks, custodians, school bus drivers, firefighters and highway repair people. for example.

Since this issue has come to light, an unprecedented number of late filings with the SEC have occurred which, of course, delays disclosure to share owners.

Second, these late filings are often considered to be technical violations of the conditions of borrowing, and that is costing companies, too. Last month, the Wall Street Journal reported that some bond holders are calling in their loans or demanding payment or large fees in exchange for an extension of their default deadlines. As many as two dozen companies were reported to have faced this dilemma over the past 18 months, and some had to pay multimillion dollar fines—fees, sorry fees.

Even more astonishing, as the Wall Street Journal has reported, we are now learning that as stocks sank after the terrorist attacks of September 11th, scores of companies rushed to issue options on top-tier executives' compensation when the stock market reached its post-attack low on September 21st, 2001.

Now comes a cascade of class-action and share owner derivative lawsuits. Once again, this scandal has brought back a number of fundamental corporate governance questions such as one, are boards condoning this behavior? Two, if not, and the boards themselves are surprised to learn of questionable backdating, then the question is where was their oversight? Three, raising questions about adequate internal and external auditor controls. Are the auditors being vigorous enough in their examination of a company's option granting practices? And last, four, investors want to know if illegalities are occurring, will the wrongdoers be swiftly and aggressively prosecuted? And will they be held accountable with civil and criminal penalties where appropriate?

Mr. Chairman, you hit the nail on the head when you said that if the public is to maintain full confidence in our public markets, the appropriate action needs to occur.

Over the past 2 months, we have approached 42 portfolio companies under investigation by the SEC. We have asked that companies perform independent investigation and that they publicly disclose all findings resulting from such investigations, regardless of the outcome. We have urged company boards of directors to develop policies that disclose how stock option grant dates are established and then publicly disclose those policies in company financial and proxy statements. We want company boards and compensation committees to conduct an audit of their executive compensation plan administrator to be sure they are acting in full compliance

with their directives. And we strongly believe that something needs to be done to ensure that corporate resources are not used to satisfy the tax and legal liability of executives implicated for this kind of wrongdoing. Such an inappropriate use of corporate assets hurts share owners twice, once by the offense of such backdating and the other by the defense when they area allowed to use company assets to defend their actions.

We urge the Committee to call on the SEC to continue to investigate and to aggressively prosecute wrongdoing.

We believe the SEC does have the authority it needs to solve this problem. The SEC has asked an extraordinary impact in regard to preventing problems when they are explicit in what constitutes good practice.

An explicit statement of policy toward option granting practices would go a long way. It would make the corporate community sit up and take notice. In essence, an ounce of prevention would make up for a lot of pounds of cure. So an explicit statement would by the SEC would grant a lot of ethical and moral authority to the alignment of interests principle.

In addition, they need to be more aggressive in enforcing the rules for the filings of Forms 3, 4 and 5. SEC rules require company stock sales to be reported on SEC forms within 2 days of execution. As we have heard earlier, we think this can be effective, but needs to be also accompanied with an alignment of interest principle statement.

We welcome the PCAOB's help by providing greater oversight of auditing practices pertaining to option grants. Their July 28th practice alert is very beneficial and we welcome their continued oversight.

I would like to close by giving our view on the issue of spring-loading of options. We believe the SEC's requirement that an issuer disclose its option grant policy will have a positive effect. It should mitigate the activity of spring-loading options in the future. However, should this not prove to be the case, we recommend that the SEC take additional steps to ensure that option grant practices are carried out in a systematic fashion, unaffected by the timing and release of material nonpublic information.

To sum up, we are going to do our part as active shareowners to demonstrate and to hold board of directors and compensation committees accountable. We will work with the SEC and the PCAOB in whatever way they deem helpful. And of course, we stand ready to assist this Committee by providing any additional information.

Finally, on behalf of the 1.4 million public servants we represent, I want to thank you once again, Mr. Chairman and Senator Sarbanes, for all the help that you are doing to restore the public trust in these financial markets.

Chairman SHELBY. We are again backed up because we have a vote on the floor and we have fewer than 10 minutes to get there.

I am going to ask some questions to all of you. You can answer them fast or you can do it for the record, because I think they are important.

I will start with you, Mr. Turner. There are corporate governance implications of backdating. Unfortunately, that appears to be the

latest example, to me, of corporate boards failing to protect shareholders.

What can policyholders do, if anything, to improve the performance of directors? Also, what about other gatekeepers, you mentioned it earlier, such as legal counsels and auditors? Where do they fit in?

I know time will not permit you to give a complete answer here, but you can elaborate for the record.

Mr. TURNER. Senator, I would be more than happy to answer any questions in writing. If you want to submit any questions, I would be more than happy.

The compensation committees have failed here. There is no question about that. The legal counsel involvement, I know, is there. That has failed——

Chairman SHELBY. You mentioned that. It is crucial, is it not?

Mr. TURNER. Yes. And the SEC has capabilities under Rule 102(e), which I actually worked on when I was at the Commission, to take action there.

Chairman SHELBY. Would you elaborate on this for the record?

Mr. TURNER. Yes. In writing or now?

Chairman SHELBY. In writing.

Mr. TURNER. I would be more than happy to, Senator. I understand the vote.

Chairman SHELBY. Dr. Lie, I cannot resist this. In your statement, you cite again your research indicating that 14 percent of all grants to top executives dated between 1996 and 2005 were backdated or otherwise manipulated, and 29 percent of firms that granted options to top executives during the same period manipulated one or more of these grants in some fashion. If this is true, this suggests a staggering problem associated with stock options.

If you want to elaborate on that for the record, I would appreciate that. I am going to give Senator Sarbanes a little time here. Will you do that?

Mr. LIE. Yes, I will certainly comment for the record.

Chairman SHELBY. Mr. Read and Mr. Schacht, corporate boards have the responsibility to keep a careful watch over executive compensation, I believe. In the wake of the backdating scandal, what specific recommendations would you two make to boards to ensure they are meeting their responsibilities? You can answer that for the record because this is a hearing record here today.

And last, Mr. Turner, spring-loading, timing option grants ahead of information that may increase the company's stock price will, I hope, be deemed illegal, or at least should be illegal, even if disclosed in options plans.

Dr. Lie, you assert that options should not be granted near major corporate announcements. And for the record, would you elaborate on that later?

Mr. LIE. Certainly.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I will be very brief because there is a vote and we have to get over to the floor. I apologize to the panel.

Chairman SHELBY. I apologize to the panel. This is a great panel.

Senator SARBANES. But we have no control over that, as you understand.

I do want to say, first of all, this has been an extremely helpful panel. I have had a chance to look at your written statements and they are enormously helpful and the supplemental will also be important.

Mr. Chairman, I want to take just a moment to comment on the people at the table and to thank them for their contributions they have been making to this effort to develop transparency and honesty and integrity in the workings of the U.S. capital markets.

Mr. Turner, of course, has had a stellar career, including his service as Chief Accountant at the SEC, where he twice was selected as receiving the Chairman's Award for Excellence. He has worked now in the private sector at Glass Lewis, is teaching out in Colorado. And we appreciate all of the contributions he has made throughout what is a long process. We are still working at it. We think we are moving it forward.

Mr. Lie, if anyone ever says to you that academics are removed from having an impact on public policy, I think you need only cite your studies and the impact they are having. You have provided important factual material and now the rigorous analysis to go with it to really have, I think, a measured impact on developments here. And it is, of course, reflected by the comments of the Chairman of the SEC today citing your work as they move forward. So we thank you very much for that.

Mr. Schacht, I want to commend the CFA and your work with them, and particularly as the Director of the Centre for Financial Market Integrity. This is what we need, is we need the professionals to take this kind of interest in sustaining high standards. You all have been committed to that. You, yourself, have I think played an important and leading role. We have turned to you for counsel and advice over the years and I want to thank you publicly here today.

Mr. Read, I note that you are a Chartered Financial Analyst, so you come under Mr. Schacht's umbrella. I simply want to say—CalPERS, of course, has a tremendous impact. They are obviously enormously significant, as some argue, as the major institutional investor. We are glad to see you move into the public sector and assume this important role as the chief investment officer of the California Public Employees' Retirement System. You are in a position, of course, there to exercise a marked influence on all of this.

So I really want to thank all of the members of the panel for the contributions you have made, that you are making now, and the contributions I anticipate you will continue to make.

Thank you.

Mr. TURNER. Chairman Shelby, I hope you are around for a long time. But I know ranking member Sarbanes will soon be leaving this fine institution. And that let me just say over the last 8 years it has been a privilege and a tremendous honor working with you. And investors and consumers and the like owe you a tremendous debt of gratitude for your fine work.

Senator SARBANES. Thank you very much.

Chairman SHELBY. Thank you all. We hate to break the panel up, but as Senator Sarbanes said, we have no choice.

The Committee is adjourned.

[Whereupon, at 12:16 p.m., the Committee was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHRISTOPHER COX

CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

SEPTEMBER 6, 2006

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

Thank you for inviting me to testify today about options backdating. This issue is one of intense public interest because it strikes at the heart of the relationship among a public company's management, its directors, and its shareholders. I appreciate the opportunity to explain the Commission's initiatives to deal with abuses involving the backdating of options.

I am especially pleased to testify together with Chairman Mark Olson of the Public Company Accounting Oversight Board. I will let Chairman Olson speak to the steps the PCAOB is taking to address these issues from the auditing regulator's perspective, but I'd like to assure the Committee, and the public, that the Commission is working in close cooperation with the PCAOB in this important area.

There are many variations on the backdating theme. But here is a typical example of what some companies did: They granted an "in-the-money" option—that is, an option with an exercise price lower than that day's market price. They did this by misrepresenting the date of the option grant, to make it appear that the grant was made on an earlier date when the market value was lower. That, of course, is what is meant by abusive "backdating" in today's parlance.

The purpose of disguising an in-the-money option through backdating is to allow the person who gets the option grant to realize larger potential gains—without the company having to show it as compensation on the financial statements.

Rather obviously, this fact pattern results in a violation of the SEC's disclosure rules, a violation of accounting rules, and also a violation of the tax laws.

The SEC has been after the problem of abusive options backdating for several years. As a preliminary step in explaining the Commission's response to the problem of fraudulent options backdating, it would be useful to put the whole topic of options compensation into some perspective.

As you know, during the last year the Commission has been intensely focused on the quality of disclosure of executive compensation. Very recently, we enacted new rules that will require, beginning with the next proxy season, the full disclosure of all aspects of executive and director pay and benefits. A key component of that disclosure will be compensation in the form of stock options, which has been a fast growing portion of executive pay since the early 1990s.

Under the new SEC rules, all of an executive's compensation will now be totaled into one number, so that it can be compared easily from person to person, company to company, and industry to industry. The new rules also require detailed disclosure of compensation in the form of stock options, which will show whether a company has backdated options, and if so, why. The purpose of the new executive compensation rules is to make the CEO's pay understandable to the shareholders who own the company.

Of course, no new SEC rules would be necessary to make executive pay transparent, if executives were all paid in the form of salary. But beyond the obvious fact that the income tax code discriminates in favor of non-salary compensation that can be taxed as capital gains, one of the most significant reasons that non-salary forms of compensation have ballooned since the early 1990s is the $1 million legislative cap on salaries for certain top public company executives that was added to the Internal Revenue Code in 1993.

As a Member of Congress at the time, I well remember that the stated purpose was to control the rate of growth in CEO pay. With complete hindsight, we can now all agree that this purpose was not achieved. Indeed, this tax law change deserves pride of place in the Museum of Unintended Consequences.

There are other accounting and tax reasons, as well, that stock options over the years were increasingly included in the compensation packages of executives and non-executives.

Beginning in 1972, the accounting rule was that employee stock options wouldn't have to be shown as an expense on the income statement—so long as the terms were fixed when the option was granted, and so long as the exercise price was equal to the market price on that day. Indeed, no expense would ever need to be recorded in the financial statements for fixed options that weren't granted in-the-money.

In addition to this favorable accounting treatment, there was a tax benefit. The million-dollar cap on the tax deductibility of executive compensation, which I mentioned earlier, doesn't apply to options granted at fair market value. So for companies that wanted or needed to pay compensation in excess of $1 million per year, the tax code outlawed deducting it if it was paid in a straightforward way through

salary, but permitted a deduction if the compensation was paid through at-the-money options.

And of course there were other reasons, many of them good ones with solid economic rationales, that companies wanted to use options as a form of compensation. For example, a properly-structured option plan can be useful in more closely aligning the incentives of shareholders and managers. And for growth companies, the use of stock options as compensation offers a way to conserve resources while attracting top-flight talent in highly competitive markets.

All of these factors have contributed to the now-widespread use of stock options as compensation. But just as option compensation increased, so did the potential for abuse. And Congress deserves credit for taking preemptive action that we now know was critical to stopping the spread of the backdating contagion.

Four years ago, in 2002, the Sarbanes-Oxley Act very presciently tightened up on the reporting of stock option grants. Before Sarbanes-Oxley, officers and directors didn't have to disclose their receipt of stock option grants until after the end of the fiscal year in which the transaction took place. So a grant in January might not have to be disclosed until more than a year later. SOX changed that, by requiring real-time disclosure of option grants. And in August 2002, shortly after the law was signed, the SEC issued rules requiring that officers and directors disclose any option grants within two business days.

Not only must option grants now be reported within two business days, but this information was among the first required to be filed electronically using interactive data. Thanks to this new data-tagging technology, the public now has almost instant access to information about stock option grants.

The following year, in 2003, the SEC took another important step that has helped increase the transparency of public company options plans. The Commission approved changes to the listing standards of the New York Stock Exchange and the Nasdaq Stock Market that for the first time required shareholder approval of almost all equity compensation plans. Companies have to publicly disclose the material terms of their stock option plans in order to obtain shareholder approval.

Very importantly, the required disclosures include the terms on which options will be granted. And companies must tell their shareholders whether the plan permits options to be granted with an exercise price that's less than the market value on the date of grant.

Then, in December 2004, the FASB issued Statement of Financial Accounting Standard 123R, which effectively eliminated the accounting advantage that had previously been given to stock options issued at-the-money. Since this new accounting rule took effect, all stock options granted to employees have to be recorded as an expense in the financial statements, whether or not the exercise price is at fair market value. This rule is nearly fully phased in.

Most recently, in January of this year, the SEC proposed that public companies be required to more thoroughly disclose their awards of in-the-money options to certain executives. The Commission also proposed that companies be required to disclose the fair value of the option on the grant date, as determined under the new accounting rules. The Commission adopted final rules on these subjects on July 26, 2006. As a result, in the next proxy season beginning in the spring, all public companies will now report this information in clear, easy to understand tabular presentations.

The tables will include:

The grant date fair value under FAS 123R (which is aggregated in the total compensation amount that is shown for each named executive officer);

- The FAS 123R grant date;
- The closing market price on the grant date if it is greater than the exercise price of the option; and
- The date the compensation committee or full board of directors took action to grant the option, if that date is different than the grant date.

Because the dates and numbers often don't tell the whole story, companies will also be required to discuss the policies and goals of their compensation programs—in plain English. The reports to investors will describe whether, and if so how, a company has engaged (or might engage in the future) in backdating or any of the many variations on that theme concerning the timing and pricing of options. For example, if a company has a plan to issue option grants in coordination with the release of material non-public information, that will now be clearly described.

So, to recap, here is what has been done by way of prophylactic rules to eliminate the opportunities for abusive backdating. First, Sarbanes-Oxley has closed the disclosure loophole that permitted months and sometimes more than a year to elapse before option grants had to be reported. Second, a new accounting rule—FAS 123R—has eliminated the accounting benefit of granting at-the-money options. And

third, the SEC's brand new executive compensation rules now require a complete quantitative and narrative disclosure of a company's executive compensation plans and goals. That enhanced disclosure will make it clear whenever options are being backdated, and it will require an explanation of the reasons.

Each of these steps by itself is an important contribution to preventing backdating abuse. In combination, they have effectively slammed the door shut on the easy opportunities to get away with secretive options grants. That's why almost all of the stock option abuses our Enforcement Division has uncovered started in periods prior to these reforms.

But while these accounting and disclosure rules changes have made it easier to detect and punish backdating abuses going forward, uncovering the problems from prior years has been quite a challenge.

A few years ago, the SEC began working with academics to decipher market data that provided the first clues something fishy was going on. One of the academics with whom the SEC worked was Erik Lie of the University of Iowa, who subsequently published a paper in 2005 that showed compelling circumstantial evidence of backdating.

Dr. Lie's data showed that before 2003, a surprising number of companies seemed to have had an uncanny ability to choose grant dates that coincided with low stock prices.

(In a follow-up paper this year, co-authored with Dr. Randall Heron of Indiana University, Dr. Lie demonstrated that this problem has greatly diminished since 2002, when the Sarbanes-Oxley Act shortened the time for reporting option grants to two business days.)

With a fair amount of detective work, and with the aid of economic research conducted by the SEC's Office of Economic Analysis, the Commission succeeded in turning what had begun as mere evidentiary threads into solid leads. Eventually, some of the evidence we began turning up was so compelling that several U.S. Attorneys took a criminal interest. Over the past several years, our inventory of backdating and related investigations has grown substantially. And beginning three years ago, the SEC has brought several enforcement actions against companies and individuals for fraudulent option practices.

For example, in 2003, the Commission charged Peregrine Systems, Inc. with financial fraud for failing to record any expense for compensation when it issued incentive stock options. The SEC's complaint alleged that at each quarterly board meeting, the company's directors would approve a total number of options for employees. The company would then allocate the options to the employees during the quarter. But the options wouldn't be priced until the day after the next quarterly Board meeting. On that day, the company looked back at the market price of its stock between the two quarterly Board meetings, and picked the lowest price. That turned the options into in-the-money grants. But even though accounting rules required that they then be recorded as compensation expense, the company didn't do that. As a result, Peregrine understated its expenses by approximately $90 million.

The following year, in 2004, the SEC brought a case involving the manipulation not of option grants, but of exercise dates. Our complaint charged that Symbol Technologies, Inc. and its former general counsel fudged option exercise dates so that senior executives could profit unfairly at the company's expense. Rather than use the actual exercise date as defined by the company's option plans, the general counsel picked the most advantageous date from a 30-day "look-back" period in order to come up with a lower exercise price. This was done without board approval or public disclosure. The SEC charged that to create the false appearance that these exercises had actually occurred on the chosen dates, the company's general counsel had instructed his staff to backdate the relevant documents, and to substitute phony exercise dates on the forms the executives used to report their option exercises to the SEC and the public. The result, according to the complaint, was a serious misstatement of the company's stock option expenses.

When the company subsequently restated its improper accounting, the cumulative net increase in reported stock option expenses was $229 million. The amount would undoubtedly have been higher had it not been for the passage of the Sarbanes-Oxley Act. Thanks to the Act's new two-day deadline for reporting options transactions by officers and its prohibition on company loans to officers and directors, the company and its general counsel had put a halt to the "look-backs" because the law had rendered the practice unfeasible.

While the alleged manipulations of option grants and exercises in these two cases were part of larger accounting fraud charges, two more recent cases have focused solely on option practices. These are the Brocade and Comverse actions that the SEC filed in July and August of this year. The executives charged in these cases are contesting the SEC's allegations.

In July, the SEC filed a civil fraud action against three former executives of Brocade Communications Systems, alleging that the former CEO and the former Vice President of Human Resources routinely backdated stock option grants to give employees favorably priced options without recording the necessary compensation expenses. Specifically, the SEC's complaint alleges that the CEO caused Brocade to grant in-the-money options to both new and current employees between 2000 and 2004, and then backdated documents to make it appear that the options were at-the-money when granted. This had the effect of concealing millions of dollars in expenses from investors.

The complaint alleges that the CEO repeatedly used hindsight to select a date with a lower stock price from the recent past as the purported option grant date, and that, to facilitate the scheme, the Human Resources executive created, or directed others to create, false paperwork making it appear that the options had been granted on the earlier date. The complaint alleged that, in some instances, employment offer letters and compensation committee minutes were falsified to suggest that options had been granted to employees before they had even been hired by the company.

The SEC's complaint also charged Brocade's former CFO, alleging that he learned of the backdating after joining the company but took no action to correct or halt the practice and instead signed Brocade's SEC filings. When these stock option practices surfaced, Brocade was required to restate and revise its financial statements for six fiscal years, from 1999 through 2004. The scheme resulted in the inflation of Brocade's net income by as much as $1 billion in the year 2000 alone. Simultaneously with the filing of the SEC's complaint, the U.S. Attorney's Office for the Northern District of California separately filed criminal charges against the former CEO and the former Vice President of Human Resources for the same misconduct.

In the second recent case, the Commission filed a civil fraud complaint last month against three former senior executives of Comverse Technology, Inc., alleging that they engaged in a decade-long fraudulent scheme to grant undisclosed, in-the-money options to themselves and to others by backdating stock option grants to coincide with historically low closing prices of Comverse common stock.

The complaint alleges that from 1991 to 2002, Comverse's founder and former Chairman and CEO repeatedly used hindsight to select a date when the closing price of Comverse's common stock was at or near a quarterly or annual low. According to the complaint, the CEO then communicated this date and closing price to Comverse's former general counsel who, with the CEO's knowledge, created company records that falsely indicated that a committee of Comverse's board of directors had actually approved the option grant on the date the CEO had picked.

The complaint also alleges that Comverse's former CFO joined the scheme no later than 1998, and assisted in selecting backdated grant dates. It is alleged that each of the three defendants realized actual illicit gains from the backdating when they sold stock they acquired from exercises of backdated options, including at least $6 million by the CEO alone. In addition, the complaint alleges that the former CEO and CFO created a slush fund of backdated options between 1999 and 2002 by causing options to be granted to fictitious employees and, later, used these options to recruit and retain key personnel.

Comverse has publicly announced that it expects to restate historical financial results for multiple years in order to record material charges for option-related compensation expenses. Simultaneously with the filing of the SEC's complaint, the U.S. Attorney's Office for the Eastern District of New York unsealed a criminal complaint charging these three executives with conspiracy to violate the antifraud provisions of the federal securities laws, wire fraud, and mail fraud by engaging in the same scheme.

These cases demonstrate some of the variations on the basic theme of fraudulent backdating that the Commission has uncovered. They involve backdated option grants that are more profitable to recipients; backdated option exercises that reduce recipients' taxes at the expense of shareholders; options granted to top executives; and options granted to rank and file employees. They involve actual personal gain to wrongdoers, and real harm to companies that failed to properly account for the options practices.

Unfortunately, these cases that I've used as illustrations are not the only matters the SEC has under investigation. The SEC's Division of Enforcement is currently investigating over 100 companies concerning possible fraudulent reporting of stock option grants. The companies are located throughout the country, and include Fortune 500 companies as well as smaller cap issuers. They span multiple industry sectors.

You should not expect that all of these investigations will result in enforcement proceedings. At the same time, we have to expect other enforcement actions will be forthcoming in the future.

The SEC's Enforcement staff is sharing information related to its investigations with other law enforcement and regulatory authorities as warranted and appropriate, including the Department of Justice, the President's Corporate Fraud Task Force, U.S. Attorney's offices around the country, the Federal Bureau of Investigation, and the Internal Revenue Service.

In our rulemaking, our provision of accounting and final regulatory guidance, and our enforcement programs, the SEC has been and will remain vigilant in the battle against fraudulent options backdating. The agency is grateful for the opportunity to provide you with this update on a very important subject. I am happy to take any questions you may have.

PREPARED STATEMENT OF MARK OLSON

CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

SEPTEMBER 6, 2006

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

I am pleased to appear today on behalf of the Public Company Accounting Oversight Board to discuss the PCAOB's response to concerns relating to certain stock option granting practices.

The PCAOB oversees the auditors of public companies, in order to protect the interests of the investing public in the preparation of informative, accurate and independent audit reports on public company financial statements. The PCAOB does not regulate accounting or disclosures by public companies; rather, the PCAOB's role is to enhance the quality of the audits of such financial statements. Simply put, the PCAOB's job is to improve the quality and reliability of public company audits, so that investors can have more confidence in audited financial statements.

The Board has a variety of tools with which to promote improved audit quality. While those tools include meaningful enforcement and disciplinary authority—important authority backing up all of our other authority—the Board has focused on implementing a supervisory model of regulation intended to focus firms on the need for high quality auditing, by helping them see where they are falling short and providing feedback and guidance that facilitates their efforts to improve. The PCAOB's approach to the audit issues that arise in connection with companies' stock option granting practices is an example of the PCAOB's emphasis on real-time improvements in audit quality.

I. Stock Option Granting Practices Have Raised Concerns About Companies' Accounting for and Disclosure of Compensation Costs

Before describing the PCAOB's response to concerns about some companies stock option granting practices, I will briefly describe the history of these concerns and certain regulatory changes that appear to have reduced the opportunity and incentive for some of the practices at issue.

A. Employee Stock Options Can Be a Useful Tool, but Concerns Have Arisen Whether Companies Have Properly Disclosed Their True Costs

As we all know, many companies issue stock options as a form of compensation and to give employees vested interests in improving their companies' performance and share prices. Such options usually give employees the right to buy shares in the future, at the price of the stock on the date of the grant. The higher the share price rises relative to the exercise price, the more valuable the options are. Well managed, stock options can be a useful and appropriate tool to attract and retain employees.

Companies' financial statements, of course, must account for and disclose options consistent with applicable accounting and regulatory requirements, and recently concerns have arisen that some may not have done so. More than 120 companies have announced they are involved in civil or criminal investigations, or internal reviews, of possible problems in the way they have granted, accounted for and disclosed stock option compensation to senior executives and other employees. Academic studies have long noted suspiciously favorable patterns related to the timing of option grants. Those patterns were largely attributed to companies planning option grants in advance of significant releases of information, until a 2005 study by University of Iowa researcher Erik Lie, who I understand will discuss his work in

the second panel of this hearing.[1] That study suggested that the favorable granting patterns could be attributable to companies having retroactively assigned option grant dates on dates their stocks hit relative lows, when the options were in fact granted weeks or months later.

B. Changes in Regulatory Requirements Appear to Have Reduced the Incidence of Suspiciously-timed Option Grants

While the extent of the problems arising from backdating and other stock option granting practices is not yet clear, two significant changes in the disclosure and accounting for stock option grants in recent years—the first initiated by, and the second supported by, this Committee—seem to have significantly reduced companies' opportunity and incentive to backdate grants.

First, the Sarbanes-Oxley Act appears to have significantly reduced the incidence of backdated option grants. Specifically, the SEC's rules implementing Section 403 of the Act now require public company officers and directors to report their receipt of stock options within two days of the grant.[2] Previously, such persons were generally not required to report option grants until 45 days after the fiscal year in which they were received.[3] Given the new filing requirement, the ability to backdate option grants to coincide with low stock prices is greatly curtailed. Indeed, subsequent research has shown that, following the change, when company insiders reported options within the new deadline, there was little to no pattern of abnormal share price increases soon afterward.[4]

Second, accounting standards for employee stock options have also gone through several changes over the last few years. Historically, the applicable accounting standard—found in Accounting Principles Board Opinion No. 25—required companies to record, as compensation cost, the amount, if any, by which the price of an employee stock option exceeded the market price on the date of the grant.[5] Compensation expenses associated with such "in-the-money" stock options was required to be reported as incurred in the period or periods in which the employee performed services for the option, which could extend for years after the option grant.[6] As a result, failure to account properly for in-the-money options could affect several financial periods.

APB Opinion No. 25 permitted companies not to record any cost, however, when employee stock options were granted at a price equal to or greater than the market price on the date of the grant. APB Opinion No. 25 thus discouraged companies from granting options at less than the prevailing market price, although such discounted options could be more lucrative for recipients. Some companies may have attempted to have it both ways, though, by granting options at prices below market on the date of the grant but treating them for accounting and tax purposes as if they were granted on a date when market prices were lower.

In 1994, the Financial Accounting Standards Board adopted Statement of Financial Accounting Standards No. 123, which encouraged companies to report the cost of stock option grants to employees at their fair value, but permitted them to con-

[1] *See* Lie, E., "On the Timing of CEO Stock Option Awards," *Management Science* (May 2005), at 802, available at http://www.biz.uiowa.edu/faculty/elie/Grants-MS.pdf.

[2] *See* SEC Release No. 34–46421, Ownership Reports and Trading by Officers, Directors and Principal Security Holders (August 27, 2002), available at *http://www.sec.gov/rules/final/34-46421.htm.* Section 403 of the Sarbanes-Oxley Act required certain company insiders to file reports of certain transactions in the securities of their companies within two days of the transaction. In addition, it required such reports to be filed electronically and available on a public, SEC Web site as well as on the company's Web site if it maintains one.

[3] Under Section 16 of the Securities Exchange Act of 1934, and the SEC's implementing rules, directors, officers and certain others are required to report transactions and holdings involving their companies' securities, including the receipt of employee stock options. Until August 29, 2002, stock options awarded under most employee stock purchase and other benefit plans were required to be reported (on the SEC's Form 5) within 45 days after the end of the fiscal year in which they were granted. In its rule implementing Section 403 of the Sarbanes-Oxley Act, the SEC required certain transactions that were formerly reportable annually on Form 5, such as option grants, to be reported, like other insider transactions, on Form 4 within Section 403's new two-day deadline.

[4] That research also shows that the previously identified pattern of stock prices rising shortly after grant dates has continued for those companies whose insiders have not complied with the two-day requirement. *See* Heron, R. and Lie, E., "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?" forthcoming in *Journal of Financial Economics,* available at http://www.biz.uiowa.edu/faculty/elie/Grants-JFE.pdf.

[5] *See* Accounting Principles Board Opinion No. 25. Accounting Principles Board Opinions were promulgated by the American Institute of Certified Public Accountants until 1973, when the Financial Accounting Standards Board was established. At that time, the FASB adopted outstanding APB Opinions, as amended, and over time has superseded them.

[6] APB Opinion No. 25, para. 12.

tinue to rely on APB Opinion No. 25, so long as they disclosed what the compensation cost would have been had they recorded such options at their fair value.[7] Finally, in 2004, the FASB eliminated APB Opinion No. 25 and, beginning with financial statements for annual periods starting after June 15, 2005, required companies to account for employee stock options at their fair value, regardless of any difference between an option's exercise price and the market price at the time of grant.[8]

II. The PCAOB Has Alerted Auditors to Use Judgment in Considering Issues Relating to Stock Option Granting Practices in Their Audits

Although much of the conduct currently under review appears to predate the Sarbanes-Oxley Act, errors related to such conduct may affect current period financial statements if employee performance related to past option grants continues into the present. That is, if an employee is still earning an option through performance (e.g., the option has not vested yet) then any compensation cost associated with the option may be allocable to the current financial period. In addition, new revelations of such conduct may trigger current auditor obligations with respect to past financial periods.

As the prevalence of problems in dating of stock option grants became clear, the PCAOB considered the implications of such problems for audits, and developed a strategy to draw those issues to auditors' attention so that they can address them in this year's audits. Specifically, the PCAOB reviewed patterns in option granting practices identified in available research, accounting firms' existing guidance to their auditors related to option granting practices, and auditing, accounting and regulatory requirements that have a bearing on audits of stock option grants. In addition, the Board discussed issues related to the timing of stock option grants at the June 2006 public meeting of its Standing Advisory Group.[9] With the encouragement of members of this advisory group, these efforts led to an Audit Practice Alert publicly issued by the Board's staff on July 28, and disseminated electronically to the more than 1,600 public accounting firms registered with the PCAOB. This tool allowed the PCAOB to provide real-time guidance as auditors begin a new audit season, without adding to the volume or complexity of the body of existing standards.

I have attached a copy of this Alert as Exhibit A. The Alert focuses auditors on several considerations related to evaluating and addressing in their audits the risk that stock option granting practices may have led to material misstatement of financial statements. In doing so, the Alert identifies existing standards that could bear on their work and applies them to the issues that have been raised regarding companies' stock option granting practices; the Alert does not establish new requirements.

Specifically, the Alert tells auditors that, in audits currently underway or to be performed in the future, they should use certain information that existing standards direct them to acquire, in order to assess the nature and potential magnitude of risks associated with their audit clients' stock option granting practices. The Alert also emphasizes that auditors must use professional judgment in making this assessment and in determining appropriate procedures to address any identified risks. In addition, the Alert reminds auditors of several procedural considerations, such as how they should approach requests for consents to use past audit opinions, including situations in which they are no longer the auditor of record. The Alert also describes circumstances in which existing standards require auditors to reconsider past audit opinions.

As the Alert points out, in assessing the risk of material misstatement of financial statements, an auditor should consider whether the company accounted for options that are still outstanding under APB Opinion No. 25. If so, and if a company granted options at a price that was lower than the market price on the true grant date, then the auditor should consider whether compensation costs were materially understated (and whether additional disclosures should have been made) in the periods of the recipient employee's performance, including the current period. The Alert also instructs the auditor to consider the effect of any errors in measuring compensation on the effectiveness of the company's internal control over financial re-

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[7] *See* Statement of Financial Accounting Standards No. 123, *Share-Based Payment,* available at http://www.fasb.org/pdf/fas123.pdf.

[8] *See* Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payments,* available at http://www.fasb.org/pdf/fas123r.pdf; *see also* SEC Release No. 33–8568 (April 15, 2005). Certain small business issuers have until annual periods starting after December 15, 2005 to comply with FAS 123(R). *Id.*

[9] The Board convened its Standing Advisory Group pursuant to Section 103(a)(4) of the Sarbanes-Oxley Act. The Group consists of a select group of experts in auditing and financial reporting, including representatives of investors, accountants, and public companies and meets three times a year to advise the Board on its standards-setting responsibilities.

porting. Finally, the Alert reminds auditors that errors in reported option compensation may have material tax implications for companies [10] and may result in material contingent obligations, including those due to pending legal and regulatory matters.

In closing, the Board appreciates the opportunity to describe how it has approached concerns about companies' accounting for employee stock options. Alerting auditors to practices and trends that may be relevant to their ongoing audits is a critical part of the PCAOB's approach to oversight. The Board's goal is to help auditors identify and address problems in financial reporting in order to protect investors' interests in high-quality and reliable audits. The PCAOB's work in the area of auditing employee stock option grants is an important step toward this goal.

I would be pleased to answer any questions.

STAFF AUDIT PRACTICE ALERT NO. 1—MATTERS RELATED TO TIMING AND ACCOUNTING FOR OPTION GRANTS—JULY 28, 2006

Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Recent reports and disclosures about issuer practices related to the granting of stock options, including the "backdating" of such grants, indicate that some issuers' actual practices in granting options might not have been consistent with the manner in which these transactions were initially recorded and disclosed. Some issuers have announced restatements of previously issued financial statements as a result of these practices. In addition, some of these practices could result in legal and other contingencies that may require recognition of additional expense or disclosure in financial statements.

This practice alert advises auditors that these practices may have implications for audits of financial statements or of internal control over financial reporting ("ICFR") and discusses factors that may be relevant in assessing the risks related to these matters.

Background

The recorded value of a stock option depends, in part, on the market price of the underlying stock on the date that the option is granted and the exercise price specified in the option. Some issuers may have granted options with exercise prices that are less than the market price of the underlying stock on the date of grant. These options are sometimes referred to as "discounted" or "in-the-money" options. Where discounted options were granted and an issuer failed to properly consider this condition in its original accounting for the option, errors in recording compensation cost, among other effects, may have resulted. These errors may cause an issuer's financial statements, including related disclosures, to be materially misstated.[1]

While this alert does not attempt to describe all of the variations in circumstances that may result in the issuance of discounted options, a range of practices appears to be involved, including——

- The application of provisions in option plans that allow for:
- the selection of exercise prices based on market prices on dates earlier than the grant date, or
- the award of options that allow the option holder to obtain an exercise price equal to the lower of the market price of the stock at the grant date or during a specified period of time subsequent to the grant date.

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[10] The Internal Revenue Code limits the deduction public companies may take for compensation paid to certain executive officers to $1 million, but it excludes from this limit compensation that is performance-based. *See* Internal Revenue Code Section 162(m). Stock option compensation may be treated as performance-based when the exercise price is equal to or more than the grant date's market price. If, on the other hand, the option provides for a discounted exercise price, it counts toward, and is subject to tax if it exceeds, the deduction limit. Companies that may have granted stock options at an exercise price that differs from the market price on the grant date, may have a tax liability, and potentially penalties, for past taxes due. If material, auditors should confirm that these items are recorded and reported in the financial statements.

[1] In addition, academic research has suggested the possibility that some issuers may have purposefully granted options immediately before the release of information that the issuer believed would be favorable to its share price. While these practices may not result in the granting of discounted options, they may create legal or reputational risks and raise concerns about the issuer's control environment.

- Preparation, or subsequent modification, of option documentation for purposes of indicating a lower exercise price than the market price at the actual grant date.
- Treating a date as the grant date when, in fact, all of the prerequisites to a grant had not yet occurred.

Available information suggests that the incidence of these and similar practices may have substantially decreased after the implementation of the shortened filing deadline for reports of option grants specified by Section 403 of the Sarbanes-Oxley Act of 2002. In August 2002, the Securities and Exchange Commission ("SEC") implemented this requirement by requiring the reporting of an option grant on Form 4 within two days of the date of grant. However, periods subsequent to the grant of an option may also be affected by improper accounting for a grant because option cost is generally expensed over the period during which the issuer receives the related services, most commonly its vesting period.

Matters for auditor consideration

Auditors planning or performing an audit should be alert to the risk that the issuer may not have properly accounted for stock option grants and, as a result, may have materially misstated its financial statements or may have deficiencies in its ICFR. For audits currently underway or to be performed in the future, the auditor should acquire sufficient information to allow him or her to assess the nature and potential magnitude of these risks. An auditor must use professional judgment in making these assessments and in determining whether to apply additional procedures in response.

In making these judgments, auditors should be mindful of the following—

Applicable financial accounting standards. Financial Accounting Standards Board Statement of Financial Accounting Standards ("SFAS") No. 123 R (revised 2004), Share-Based Payment, applies to issuer reporting periods beginning after June 15, 2005 (December 15, 2005 for small business issuers). Accounting for options was, however, previously governed by other accounting standards and related interpretations, specifically Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and SFAS No. 123, Accounting for Stock-Based Compensation. If an auditor determines that it is necessary to consider the accounting for option grants and related disclosures in financial statements of a prior period, the auditor should take care to determine the applicable generally accepted accounting principles in effect in those periods and to consider the specific risks associated with these principles.

- *Accounting for discounted options.* For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, the issuer may have been required to record additional compensation cost equal to the difference in the exercise price and the market price at the measurement date (as defined in APB 25). In periods in which the issuer has recorded option compensation cost using the fair value method as allowed by SFAS No. 123, or as required by SFAS No. 123 R (revised 2004), the impact on the calculated fair value of options of using an incorrect date as the grant date would depend on the nature and magnitude of changes in conditions that affect option valuation between the incorrect date used and the actual grant date. In all cases, the compensation cost of options should be recognized over the period benefited by the services of the option holder.
- *Accounting for variable plans.* For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, an option with terms allowing a modification of the exercise price, or whose exercise price was modified subsequent to the grant date may require variable plan accounting. Variable option accounting requires that compensation cost be recorded from period to period based on the variation in current market prices. In periods in which the issuer records option compensation cost using the fair value method as allowed by SFAS No. 123, or as required by SFAS No. 123 R, the right to a lower exercise price may constitute an additional component of value of the option that should be considered at the grant date. In all cases, the cost of options should be recognized over the period benefited by the services of the option holder.
- *Accounting for contingencies.* If the consequences of the issuer's practices for stock option grants or its accounting for, and disclosure of, option grants result in legal or other contingencies, the application of SFAS No. 5, *Accounting for Contingencies,* may require that the issuer record additional cost or make additional disclosures in financial statements.

- *Accounting for tax effects.* The grant of discounted stock options may affect the issuer's ability to deduct expenses related to these options for income tax purposes, thereby affecting the issuer's cash flows and the accuracy of the related accounting for the tax effects of options.

Consideration of materiality. In evaluating materiality, auditors should remember that paragraph .11 of AU sec. 312, *Audit Risk and Materiality-in Conducting an Audit*, and SEC Staff Accounting Bulletin: No. 99—*Materiality* emphasize that both quantitative and qualitative considerations must be assessed. Quantitatively small misstatements may be material when they relate to unlawful acts or to actions by an issuer that could lead to a material contingent liability. In all cases, auditors should evaluate the adequacy of related issuer disclosures.

Possible illegal acts. Auditors who become aware that an illegal act may have occurred must comply with the applicable requirements of AU section ("AU sec.") 317, Illegal Acts, and Section 10A of the Securities Exchange Act of 1934. Section 10A, among other things, requires a registered public accounting firm to take certain actions if it "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred...." If it is likely that an illegal act has occurred, the registered public accounting firm must "determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages." The registered public accounting firm must also inform the appropriate level of management and assure that the audit committee is adequately informed "unless the illegal act is clearly inconsequential." The auditor may, depending on the circumstances, also need to take additional steps required under Section 10A if the issuer does not take timely and appropriate remedial actions with respect to the illegal act.

A. Effects of options-related matters on planned or ongoing audits

In planning and performing an audit of financial statements and ICFR, the auditor should assess the nature and potential magnitude of risks associated with the granting of stock options and perform procedures to appropriately address those risks. The following factors are relevant to accomplishing these objectives—

- Assessment of the potential magnitude of risks of misstatement of financial statements and deficiencies in ICFR related to option granting practices. This assessment should include consideration of possible indicators of risk related to option grants, including, where appropriate:
  - The status and results of any investigations relating to the timing of options grants conducted by the issuer or by regulatory or legal authorities.
  - The results of direct inquiries of members of the issuer's management and its board of directors that should have knowledge of matters related to the granting and accounting for stock options.
  - Public information related to the timing of options grants by the issuer.
  - The terms and conditions of plans or policies under which options are granted; in particular, terms that allow exercise prices that are not equal to the market price on the date of grant or that delegate authority for option grants to management. In these situations, auditors should also consider whether issuers have other policies that adequately control the related risks.
  - Patterns of transactions or conditions that may indicate higher levels of inherent risk in the period under audit. Such patterns or conditions may include levels of option grants that are very high in relation to shares outstanding, situations in which option-based compensation is a large component of executive compensation, highly variable grant dates, patterns of significant increases in stock prices following option grants, or high levels of stock-price volatility.
- In planning and performing audits, auditors should appropriately address the assessed level of risk, if any, related to option granting practices. Specifically:
  - In addition to the general planning considerations for financial statement audits identified in AU sec. 311, Planning and Supervision, the auditor should consider:
    - The implications of any identified or indicated fraudulent or illegal acts related to option grants to assessed risks of fraud (AU sec. 312.07 and AU sec. 316, Consideration of Fraud in a Financial Statement Audit); the potential for illegal acts (AU sec. 317, Illegal Acts by Clients); or the assessment of an issuer's internal controls (AU sec. 319, Internal Control in a Financial Statement Audit).

  - The scope of procedures applied to assess the potential for fraud (AU sec. 316) and illegal acts (AU sec. 317).
- The nature, timing, and extent of audit procedures applied to elements of the financial statements affected by the issuance of options. In particular, this assessment should include consideration of:
  - The need for specific management representations related to these matters (AU sec. 333, Management Representations) and the nature of matters included in inquiries of lawyers (AU sec. 337, Inquiry of a Client's Lawyer).
  - Where applicable, the result of tests of internal controls over the granting, recording, and reporting of option grants.
  - The need, based on the auditor's risk assessment, for additional specific auditing procedures related to the granting of stock options.

For integrated audits performed as described in PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* ("AS No. 2"), the auditor should consider the implications of identified or potential accounting and legal risks related to options in planning, performing, and reporting on audits of ICFR. In addition, as discussed in paragraphs 145–158 of AS No. 2, the results of the audit of ICFR should be considered in connection with the related financial statement audit.

B. Auditor involvement in registration statements

In cases where an auditor is requested to consent to the inclusion of his or her report, including a report on ICFR, in a registration statement under the Securities Act of 1933, AU sec. 711, Filings Under Federal Securities Statutes, provides that the auditor should perform certain procedures prior to issuing such a consent.[2]

- Paragraph .10 of AU sec. 711 provides that an auditor should perform certain procedures with respect to events subsequent to the date of the audit opinion up to the effective date of the registration statement (or as close thereto as is reasonable and practical under the circumstances). These procedures include inquiry of responsible officials and employees of the issuer and obtaining written representations from them about whether events have occurred subsequent to the date of the auditor's report that have a material effect on the financial statements or that should be disclosed in order to keep the financial statements from being misleading. The auditor should consider performing inquiries and obtaining representations specifically related to the granting and recording of option grants.
- Paragraph .11 of AU sec. 711 provides that a predecessor auditor that has been requested to consent to the inclusion of his or her report on prior-period financial statements in a registration statement should obtain written representations from the successor auditor regarding whether the successor auditor's audit and procedures with respect to subsequent events revealed any matters that might have a material effect on the financial statements reported on by the predecessor auditor or that would require disclosure in the notes to those financial statements. If the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, the successor auditor should apply paragraphs .21 and .22 of AU sec. 315.[3]
- If either the successor or predecessor auditor discovers subsequent events that require adjustment or disclosure in the financial statements or becomes aware of facts that may have existed at the date of his or her report and might have affected the report had he or she been aware of them, the auditor should take the actions described in paragraph .12 of AU sec. 711. In addition, where the auditor concludes that unaudited financial statements or unaudited interim financial information presented, or incorporated by reference, in a registration statement are not in conformity with generally accepted accounting principles, he or she should take the actions described in paragraph .13 of AU sec. 711.

C. Effects of option-related matters on previously issued opinions

If an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to him or her at

[2] Under Paragraph 198 of AS 2, the auditor should apply AU sec. 711 when the auditor's report on management's assessment of ICFR is included in filings under federal securities statutes.

[3] In cases in which a predecessor auditor reissues his or her report on financial statements included in a filing under the Securities Exchange Act of 1934, the predecessor auditor should follow the directives in paragraphs .71 through .73 of AU sec. 508.

the date of the report, and which is of such a nature and from such a source that he or she would have investigated it had it come to his or her attention during the course of the audit, he or she should take the actions described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

Contact information

Inquiries concerning this Practice Alert may be directed to—

Phil D. Wedemeyer, Director, Office of Research and Analysis, 202-207-9204, *wedemeyer@pcaobus.org.*

Thomas Ray, Chief Auditor and Director of Professional Standards, 202-207-9112, *ray@pcabous.org.*

PREPARED STATEMENT OF LYNN TURNER

MANAGING DIRECTOR OF RESEARCH, GLASS LEWIS & CO., LLC.

SEPTEMBER 6, 2006

Chairman Shelby, Ranking Member Sarbanes, thank you for the opportunity to testify before the Senate Banking Committee regarding the growing stock-option scandal. As noted in Appendix A, the number of companies presently caught up in this scandal has mushroomed and now totals in excess of 120. It grows and multiplies each week. Professors Lie and Heron have noted that 18.9% of the unscheduled, at-the-money option grants to top executives during the period 1996–2005 were backdated. This includes a 10% rate subsequent to changes in regulations in 2002, requiring more timely reporting of these transactions. At the same time, investor groups such as the Council of Institutional Investors, the CFA Institute, and leading institutional investors from Australia, Canada, England, the Netherlands, New York, Connecticut, Florida, California, Illinois and elsewhere have written the Securities and Exchange Commission (SEC) expressing "great concern" regarding the backdating of options. Also, I would note the Council of Institutional Investors has written letters to approximately 1,500 companies inquiring of their policies with respect to backdating. To date, approximately 200 of those companies have responded, leaving a big question mark with respect to the other 1,300.

But before I begin, I think it is worth noting that, as Business Week recently reported, the option scandal had its beginnings, in part, in Congress in 1994. That is when the Senate passed a resolution opposing the efforts of the Financial Accounting Standards Board (FASB) to create greater transparency for options. As a direct result of this overreaching interference, during the ensuing 11 years, companies in the Standard & Poor's 500-stock index alone excluded *$246 billion* in options compensation from net income figures, overstating earnings by 7%.[1]

Fortunately, when efforts to increase transparency of options arose once again in the aftermath of Enron, investors had a new champion. Chairman Shelby, your courage, your leadership, and your vision of the necessity of honest accounting and full and fair disclosure for the capital markets almost single-handedly prevented Congress from repeating its mistakes of the past. Your support of the FASB's efforts to reflect the economic reality of options in financial statements ensured greatly enhanced transparency for the 90 million Americans investing in the capital markets. That effort, despite an onslaught of opposition, including by companies now caught up in the option scandal, has helped to mitigate the scandal's future potential impact.

Let me also say that, as a business executive, I have been both a giver and a receiver of stock options. In the past I have not opposed their use in a thoughtful manner. However, the focus of their use must be on what Franklin Roosevelt called the ". . . thrill of achievement, in the thrill of creative effort."[2] Not the self serving, single-minded pursuit of evanescent profits. Not abuses of investor interests through the repricings, early accelerations, or early vesting of options that have become all too common.

I firmly believe that what one manages is what one measures. As a result, requiring the measurement and expensing of the value of options granted as compensation will increase the focus and attention they duly deserve and will help eliminate abuses.

Capital Markets Depend on Integrity and Transparency

As many learned during the early years of this decade—when the markets lost trillions in value, with stockholders actually withdrawing cash—the ability of the

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[1] Business Week, August 31, 2006 in citing statistics from *The Analyst's Accounting Observer.*

[2] Franklin Delano Roosevelt, First Inaugural Address, Washington, D.C., March 4, 1933.

U.S. capital markets to attract capital depends on investors having confidence in the integrity and transparency of the markets. Confidence is earned over time through honest and fair markets that provide investors with the material information they need to make informed decisions.

But that confidence can quickly erode if investors believe the markets have become "rigged," and one party is given an unfair advantage over others. Unfortunately, that is what occurs when an executive who has a fiduciary relationship of trust with shareholders engages in either "backdating" or "spring-loading" of options. The executive uses confidential information, available as a result of his or her position in the company, for self-serving gains. Such is the beginning of what is referred to as a manipulative or deceptive device.

Sam Raybum, a legend in this town, once said "men charged with the administration of other people's money must not use inside information for their own advantage."[3] Indeed, the Securities and Exchange Act of 1934, passed with the help of Rayburn's leadership, includes a provision that makes it unlawful for people to use" . . . any manipulative or deceptive device. . ." in connection with the purchase or sale of a security. Likewise, in the '34 Act and related rules, Congress and the SEC have made it unlawful for the votes of investors to be solicited in a proxy that contains false or misleading statements with respect to material facts. In particular, Rule 14a–9 specifically addresses false and. misleading statements in a proxy provided to investors, including omission of material facts.

With that as background, I would first like to focus my remarks on "spring-loading" of options.

Spring-loading

Let's say a government contractor receives notice from the government that it has been awarded a profitable contract. The company's stock is trading at $15 before news of the new contract is disclosed to investors. Three days later, upon the announcement and disclosure of the contract, the company's stock price increases to $20. But before the disclosure is made, while the stock is still trading at $15, a grant of options to the top executives is made with an exercise price of $15. In essence, the options have been "spring-loaded" to the tune of $5.

There are a few key points I want to highlight with respect to this spring-loading example. First, the options were not granted at the fair value of the underlying stock. It is clear if the market had the information on the date of the grant with respect to the new contract, the stock would have traded higher. Second, if properly valued using all the available information at the time of the option grant, the grant would have resulted in a benefit to the recipient, as it was granted in-the-money, not at the market price. And finally, generally accepted accounting principles (GAAP) would require the value of such in-the-money options to be expensed under the old accounting rule, Accounting Principles Board Opinion No. 25, or the new accounting rule, FASB statement No. 123R.

Now, some would lead you to believe that granting such "in the money" options, or spring-loading, is not a bad thing, not illegal. I beg to differ.

First of all, research has shown that companies include in their annual reports, disclosures such as:

"The Company accounts for those plans using the intrinsic value method prescribed by APB Opinion No. 25, Accounting for Stock Issued to Employees. No stock-based compensation cost is reflected in the statements of operations, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant."

Or:

"As permitted by Statement 123, the Company currently accounts for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options."

In addition, I have seen proxy disclosures that indicate options are being granted at the fair value of the underlying stock, and that no gain is available to the executive without further stock appreciation. In cases involving potential spring-loading, they fail to properly disclose the options were granted in the money. In one instance, the disclosure noted the grant of options was designed to align the executive's interests with those of the stockholders, without noting the spring-loading. Likewise, the proxy disclosures fail to note that, when options have been spring-loaded and granted "in the money" to the executives, there may be significant negative tax consequences.

[3] H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13. Cited by the U.S. Supreme Court in *Blau vs. Lehman, et al.*, 368 U.S. 403 (1962).

If a company has engaged in spring-loading, disclosures such as those above would be misleading to investors and other users of financial statements. First, since the option had an embedded value on the date of grant, the company was wrong in saying they were granted at the market value. Second, given spring-loaded options are "in the money" at the date of grant, the company should have reported compensation expense under the intrinsic value method required by APB 25. Likewise, any proxy disclosures noting options were granted at fair value, when they in fact were not, would be misleading. So would statements that the options were granted pursuant to plans requiring the options be granted at fair value. The failure to disclose the significant tax implications of not granting the options at the money also would be misleading.

Unfortunately, I have not seen disclosures of the nature the SEC has recently adopted with respect to a company that has a ". . . plan or practice to select option grant dates . . . in coordination with the release of material non-public information that is likely to result in an increase in its stock price, such as immediately prior to a significant positive earnings . . . announcement." I could not agree more with the SEC when it said "the Commission believes that in many circumstances the existence of a . . . plan . . . to time the grant of stock options to executives in coordination with material non-public information would be material to investors . . ."[4] The failure of companies with spring-loading plans to disclose that information is an omission of a material item of interest to investors.

Accordingly, I believe that disclosures made in the past regarding spring-loaded option grants will be found in all too many instances to have been false and misleading, violating the securities laws and regulations.

Integrity of Management

Equally important, I believe information regarding the integrity of management is always vitally important and material to investors. After all, what investors want to give management their money when the integrity of that management team is in question?

Yet executives who are found to have spring-loaded or backdated their options will find their integrity challenged as a result of representations they have made to their companies' auditors, as well as certifications they have made to their companies' shareholders. When the CEO and CFO complete the financial statements for a company, they must provide the auditors with a representation letter that indicates they have prepared the financial statements in accordance with generally accepted accounting principles. This would include the proper accounting for stock options, including recognizing expense for spring-loaded or backdated options that were granted "in the money." At the same time, the CEO and CFO must certify to investors that the company has properly prepared its financial statements and has effective internal controls, including over the accounting for options. However, if these executives have engaged in spring-loading (or backdating) options, failed to properly account for these options, and failed to note this in their representations to auditors and certifications to investors, consistent with the types of misleading disclosures I discussed earlier, the executives would have once again violated securities laws and regulations.

Accordingly, given that spring-loading certainly can and probably has resulted in improper financial reporting and misleading disclosures, raising serious questions about the integrity of management, I would challenge those who have argued its acceptability to take a closer look at the filings of companies who have engaged in this behavior. I think they will find them most troublesome from the perspective of an investor, as well as a securities regulator.

Late Filings

Now I would like to turn my attention to another issue of concern. That is the issue of late filings. In particular, late filings of the forms the SEC requires to be filed within two days by certain executives or corporate board members, namely Form 4's.

A sample of actual Form 4's for the company, Children's Place Retail Stores, is included as Appendix B. These forms are required to be filed on a timely basis so investors have insights into transactions key insiders are entering into with respect to the stock of the company. In fact, Enron and other corporate scandals highlighted just how late this information was being filed at times, much to the detriment of investors. And, in response to this concern, Congress adopted Section 403 of the Sar-

[4] Securities and Exchange Commission, Executive Compensation and Related Person Disclosure. Release Nos. 33–8732;34–54302; File No. S7–03–06.

banes-Oxley Act of 2002 to ensure investors received the information within two business days.

However, we continue to see late filings, or, quite frankly, Form 4's that are not filed at all. For example, if you look closely at one of the Children's Place Form 4 filings, you will see it was filed on May 20, 2005. At the same time, the company states that the transaction date was on April 29, 2005, well outside the two-day requirement of SOX. Of interest in this instance is that Children's Place's stock price increased $9.58, or 26%, to $46.79 between the filing date of the Form 4 and the disclosed transaction date. On May 5, 2005, the company issued a press release raising fiscal-year earnings guidance to $2.15–$2.25 a share from $2.10-$2.20 a share. Children's Place does not have an established pattern of granting executive options at this time each year. And while one might well be hesitant to draw conclusions as to why the Form 4 was filed late, the April 29th date did provide an unusually low exercise price for the options.

If the Form 4's had been filed on time, investors would not have to wonder about the integrity of the grant date. That is why it is important the SEC begin to enforce the provisions of SOX that require timely filing. And while I have used Children's Place merely as an example, it is not alone. Companies such as Novatel Wireless, P.F. Chang's, Activision, Sigma Designs and SafeNet are all on a growing list. In fact, if you look at SafeNet's proxy disclosures, which I have included as Appendix C, you will see the filings themselves show the company repeatedly abused the rules. And despite this constant pattern of late filings, I am not aware of any formal SEC sanctions being handed in a timely fashion to ensure the company and its insiders commence complying with the law. To its credit, SafeNet has disclosed this shortcoming to investors, something that cannot be said for other late filers.

Restatements and Internal Control Weaknesses

Another topic worth noting is the 48 companies that have recently reported they will be delaying providing their investors and the SEC with their financial statements until they are able to complete their own investigations of the matter. Of these companies, 19 have announced they will be restating their financial statements, and certainly a good portion of the remaining 29 could join that group. Another 22 companies that were not late filers this quarter have also announced restatements.

In addition, 18 of the companies listed in Appendix A also reported they had material weaknesses related to their accounting for stock options. As you are well aware, Congress since 1977 has required companies to maintain adequate internal controls that will provide reasonable assurance their financial statements have been properly prepared. Yet we are finding, no doubt due to Section 404 of SOX, that companies have not maintained those necessary controls. Nor in prior years have the executives reported these weaknesses to investors as required by Section 302 of SOX. Both Sections 404 and 302 of SOX—tools that were not available when this scandal initially began in the Enron era—should help aid the law enforcement agencies in cracking down on violators.

Where Were The Gatekeepers?

In what has become a recurring theme in recent years, investors are asking once again: Where were the gatekeepers, including legal counsel and independent auditors?

As both a business executive and corporate board member, my experience has been that legal counsel—general counsel, if the position exists—often takes the lead along with the CEO, CFO and vice president in charge of human resources in making the determinations as to option grants, including grant dates. Based on that experience, I would expect legal counsel to have been aware of backdating of options if it occurred. Obviously, one would hope that any legal counsel involved would have had sufficient common sense to have objected to backdating or spring-loading. However, that appears not to have been the case for at least some of the companies.

With respect to independent auditors, I suspect they failed to be skeptical enough with respect to options, despite their known effect on how at least some executives behave. All too often, it appears they did not pay sufficient attention to the disclosures the company made with respect to option plans and grants. All too often, I have seen auditors pay way too little attention to disclosures in footnotes, merely treating them almost as an afterthought towards the end of an audit. In at least one circumstance now involved in litigation, it has been argued the auditors even gave their blessing to backdating.

However, as a former auditor, I certainly believe that, in some instances, executives at a company could have intentionally withheld critical information on option grants and company performance from the auditors that the auditors otherwise

would not have learned of. Accordingly, the auditors would not have detected the misstated financial statements.

Steps to Remediate and Prevent a Recurrence of The Option Scandal

One will naturally ask why a professor, living among the cornfields of Iowa, and two Wall Street Journal reporters were able to bring this scandal to light well before the current rise in the number of law-enforcement investigations. In addition, the question of who thought up the concept of backdating remains unanswered. Hopefully it will be answered through the investigations underway. I will leave those questions for the committee to pursue.

Yet I do think it is important to focus not just on what has transpired, but also on what steps should be taken to ensure it is not repeated.

Benefits of SOX

Certainly, the passage of SOX has helped and will help mitigate the potential for abuse. Its requirements mandate more timely reporting of transactions to investors. They mandate that executives establish their accountability for the company's financial statements and internal controls. They mandate independent examinations of those controls. And they make it unlawful to mislead independent auditors. I also believe the newly adopted disclosure requirements of the SEC will facilitate greater transparency, as well. I suspect the media attention this matter has received has also sharpened the focus of corporate boards on the issue of grant dates, backdating and spring-loading as well.

But, as we have seen in the past, the allure and upside to options are great, and they at times seemingly have a drug-like effect on rational people's thinking. As a result, I don't believe that only the changes made to date will prevent a recurrence of the problem.

Need for Stricter Enforcement and Adequate Resources

I think the changes made to date must be followed up with stricter enforcement of the new rules, which it appears to me has not yet occurred. The SEC needs to send a clear message through its enforcement actions that investors must be provided information on these transactions through timely filed Form 4's, coupled with honest and transparent disclosures in financial statements, annual reports and proxies. Companies that have solicited the votes of investors based on misleading disclosures need to be held accountable. While the SEC has announced some 80 ongoing investigations, I am worried that when we look back on this episode in five years or so, we will find these investigations will not have resulted in holding the responsible individuals accountable. This includes gatekeepers who are found to have been actively involved with problematic option grants. Certainly the SEC's actions will have fallen short if executives, board members or gatekeepers are found to have backdated and/or spring-loaded options in violation of laws, and are not required to disgorge themselves of these ill-gotten gains.

One reason for that concern is the decreasing level of resources being dedicated to the enforcement activities of the SEC staff, including the reviews of filings. For example, in its fiscal 2007 congressional budget request, the SEC includes a request for 1,187 full-time equivalents for the enforcement division and 463 FTE's for the division of corporation finance, which reviews the filings. Both of these numbers represent declines from the 1,216 budgeted and 1,232 actual FTE's for the enforcement division in 2006 and 2005, respectively. They also reflect a comparable decline from 478 budgeted and 495 actual FTE's, respectively, for corporation finance. And while spending is projected to be up slightly in 2007, it appears that increases in salaries are coming at the expense of available staff. I would hope Congress would rethink the wisdom of such cuts to an agency so critical to the capital markets and investors.

At the same time, the SEC's budget request stated the staff were piloting a number of technology tools to assist them with enforcement and monitoring of filings. Congress should ensure these pilot programs turn into reality. For example, the SEC staff should have the technology available to them that would automatically match up transaction and filing dates from all Form 4's and generate exception lists whenever a filing is outside the two-day requirement. This should not have to be a manual procedure. At the same time, technology is available whereby option-grant dates can be compared to stock values. Certainly the SEC staff should have these tools available to them to permit quicker identification of these issues.

I would encourage the SEC to step up its enforcement of Section 403 of SOX. As part of each triennial review of a company's filings mandated by SOX, I believe the SEC staff should review the company's compliance with the law. And where there are repeat offenses, such as occurred with Safe Net, the SEC should hand out appropriate sanctions AND fines to those late with their filings.

I certainly do support the new SEC disclosure requirements, which are a positive step forward. However, once again, how good they turn out to be will depend on whether they are enforced.

One of the new requirements includes disclosure of the value of option grants calculated in accordance with the new FASB accounting standard. That means these disclosures and the values reported as compensation expense will be only as good as the implementation of that rule. In its comment letter to the SEC, the Council of Institutional Investors stated:

> ". . . the Council believes that the backdating controversy illustrates that the financial accounting and reporting for employee stock option grants is an area in which there is a high risk of intentional misapplication of the accounting requirements. The Council notes that those companies involved in the backdating controversy appear to have failed to comply with the rules-based exception contained in the Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("Opinion25")
>
> . . . The council, however, is concerned that some preliminary evidence surrounding the adoption of Statement 123R appears to indicate that some companies may be intentionally understating certain inputs required by the standard in an effort to continue the Opinion 25 practice of understating compensation costs and inflating reported earnings. [Footnote omitted] The Council believes that the benefits of Statement 123R will not be fully realized by investors unless and until the SEC closely monitors and rigorously enforces a high quality implementation of the standard's requirements."

I share the council's concern and believe it is a valid one. Again, this is an issue of enforcement. If the SEC chooses to go "soft" on the enforcement of the new accounting standard, then it should not be surprised when investors begin to question its commitment to investor protection and the integrity of financial statements.

Changes for Corporate Boards to Consider

Corporate boards, I believe, must also change from being passively involved to one of active involvement with option grants. Corporate boards should be setting the grant dates. I believe it would certainly be a best practice if they chose a set time frame, such as at the annual stockholders meeting, to award option grants.[5] At a minimum, grants should not be permitted during the typical "blackout periods," when the possibility exists there is material information available that has not yet been disclosed to investors.

In the United Kingdom, I understand that a company is required to notify the stock exchange on the date an option grant is made. Certainly that is a very good practice that should be considered here.

Finally the treasurer of the state of Connecticut has stated that compensation consultants may be conflicted as a result of services they provide to the executive team. The treasurer has recommended that the SEC require disclosure of such services as an initial step, a recommendation I concur with.

Bringing Closure to The Scandal

Finally, let me close by noting that investors have now suffered through a growing list of companies disclosing they have been caught up in the backdating scandal. In the mid 1970s, the SEC faced a similar scandal involving illegal payment of corporate bribes. After initially involving a dozen or so companies, more than 400 companies were found to have engaged in improper payments and behavior, along with lax accounting in their books and records. Given the magnitude of the issue confronting the agency, and realizing its enforcement resources were going to be insufficient to deal with the breadth of the scandal, then-SEC Chairman Roderick M. Hills announced a program urging companies to self-investigate and, when problems were found, provide independent reports to the SEC along with full disclosure to investors. In turn, the SEC stated that, with adequate disclosure, it would not pursue enforcement remedies unless fraudulent behavior was found, in which case the SEC reserved its legal rights.

Today, I believe the SEC faces a similarly daunting task. With a reported 80 investigations already underway, I see no way the SEC staff, with current resources, can or will adequately investigate all of these cases. As we also continue to find dubious cases of option granting in our own research, I believe we will find many more—perhaps hundreds of companies—that have yet to report inappropriate disclosure and accounting of stock-option grants. Certainly, Prof. Lie's research makes that a possibility.

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[5] New grants for new employee hires may need to be tied to the timing of their hiring.

Accordingly, I would hope this committee would urge the SEC to undertake a program, as it has in the past, to more quickly bring this issue to the forefront and to conclusion, while allowing companies to get on with their business. Investors should no longer have to suffer this Chinese water torture, as news of another company backdating continues to drip out.

In Closing

Let me close by noting that I have devoted little time to backdating of options. This is a practice akin to winning the lottery or betting on a race, after the race is over. For that reason, there has been universal agreement that backdating of options is unlawful and should be punished with the full force of the laws, especially when it is done through backdating of documents or involves the misleading of auditors or corporate boards. As such, I have left that topic to be addressed by others today.

However, I do believe spring-loading of options cannot be justified anymore than backdating. It once again provides the insider with an advantage other corporate shareholders do not receive, and I have yet to see it done with full and fair disclosure and appropriate treatment in the financial statements. Once that is forced to occur, and sunlight is focused on this affliction, I suspect this practice will cease to exist. Indeed, it is this lack of transparency that has permitted some unscrupulous executives to engage in doing what they will not do when fully exposed.

Appendix A

Listing of Companies Announcing Restatements, Internal or Government Investigations Related to Option Backdating

At least 128 companies have announced internal reviews, SEC inquiries, or Justice Department subpoenas related to their historical stock-option grants. We provide details for these companies in the following table. (List as of Sept. 1, 2006.)

Company	Ticker	Market value ($M)	Internal	SEC	DoJ	Shareholder suits	Criminal cases	Executive or director departures	Restatements	Late filings	Material weaknesses	Accel. vesting	FASB comment letters	IESOG	Auditor
1 Activision Inc.	ATVI	3,686	Yes	Yes		Yes									PricewaterhouseCoopers
2 Affiliated Computer Services Inc.	ACS	5,862	Yes	Yes	Yes	Yes				Yes					PricewaterhouseCoopers
3 Affymetrix Inc.	AFFX	1,383	Yes						Yes	Yes					Ernst & Young
4 Alkermes Inc.	ALKS	1,670	Yes	Yes					Yes	Yes	Yes		2004		Deloitte & Touche
5 Altera Corp.	ALTR	6,729	Yes	Yes	Yes	Yes			Yes	Yes	Yes		2004		PricewaterhouseCoopers
6 American Tower Corp.	AMT	14,594	Yes	Yes	Yes	Yes			Yes	Yes					Deloitte & Touche
7 Amkor Technology Inc.	AMKR	946	Yes			Yes			Yes	Yes		Yes			PricewaterhouseCoopers
8 Analog Devices Inc.	ADI	9,823		Yes	Yes	Yes		Yes				Yes			Ernst & Young
9 Apollo Group Inc.	APOL	7,783	Yes	Yes	Yes					Yes					Deloitte & Touche
10 Apple Computer Inc.	AAPL	56,681	Yes			Yes			Yes	Yes			1994		KPMG
11 Applied Micro Circuits Corp.	AMCC	780	Yes	Yes	Yes					Yes		Yes			Ernst & Young
12 ArthroCare Corp.	ARTC	1,224	Yes	Yes											PricewaterhouseCoopers
13 Asyst Technologies Inc.	ASYT	337	Yes	Yes	Yes	Yes				Yes		Yes			PricewaterhouseCoopers
14 Atmel Corp.	ATML	2,622	Yes	Yes		Yes				Yes					PricewaterhouseCoopers
15 Autodesk Inc.	ADSK	7,838	Yes										1994		Ernst & Young
16 Barnes & Noble Inc.	BKS	2,295	Yes	Yes	Yes	Yes									BDO Seidman
17 BEA Systems Inc.	BEAS	4,643	Yes									Yes			Ernst & Young
18 Blue Coat Systems Inc.	BCSI	182	Yes	Yes		Yes				Yes	Yes				Ernst & Young
19 Boston Communications Group Inc.	BCGI	39	Yes	Yes		Yes				Yes		Yes			Ernst & Young
20 Broadcom Corp.	BRCM	15,219	Yes	Yes		Yes			Yes	Yes				Yes	Ernst & Young
21 Brocade Communications Systems Inc.	BRCD	1,469	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes				KPMG
22 Brooks Automation Inc.	BRKS	1,020	Yes	Yes	Yes	Yes		Yes	Yes	Yes	Yes	Yes	2004		PricewaterhouseCoopers
23 CA Inc.	CA	13,175	Yes						Yes	Yes	Yes		1994		KPMG
24 Cablevision Systems Corp.	CVC	6,428	Yes	Yes	Yes				Yes	Yes					KPMG
25 Caremark Rx Inc.	CMX	24,264		Yes	Yes	Yes							1994		Ernst & Young
26 CEC Entertainment Inc.	CEC	971	Yes	Yes						Yes					Deloitte & Touche
27 Ceradyne Inc.	CRDN	1,160	Yes							Yes					PricewaterhouseCoopers
28 Cheesecake Factory Inc.	CAKE	1,881	Yes	Yes		Yes			Yes	Yes					PricewaterhouseCoopers
29 Chordiant Software Inc.	CHRD	183	Yes	Yes						Yes					BDO Seidman
30 Clorox Co.	CLX	9,056	Yes			Yes							1994		Ernst & Young

Source: Glass Lewis, Wall Street Journal, Bloomberg, Reuters, Stanford Securities Class Action Clearinghouse, FASB, Analyst's Accounting Observer, company filings. See legend for column explanations.

Company	Ticker	Market Value ($M)	Internal	SEC	DoJ	Shareholder suits	Criminal cases	Executive or director departures	Restatements	Late filings	Material weaknesses	Accel. vesting	FASB comment letters	IESOC	Auditor
31 CNET Networks Inc.	CNET	1,319	Yes	Yes	Yes				Yes	Yes					KPMG
32 Computer Sciences Corp.	CSC	8,374	Yes	Yes	Yes	Yes									Deloitte & Touche
33 Comverse Technology Inc.	CMVT	4,129	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes					Deloitte & Touche
34 Corinthian Colleges Inc.	COCO	1,085	Yes	Yes		Yes						Yes			Ernst & Young
35 Crown Castle International Corp.	CCI	6,958	Yes	Yes						Yes					KPMG
36 Cyberonics Inc.	CYBX	390	Yes	Yes	Yes	Yes				Yes					KPMG
37 Delta Petroleum Corp.	DPTR	937	Yes	Yes	Yes										KPMG
38 Dot Hill Systems Corp.	HIFI	150	Yes			Yes				Yes		Yes			Deloitte & Touche
39 DRS Technologies Inc.	DRS	1,585		Yes	Yes										KPMG
40 Electronic Arts Inc.	ERTS	15,551	Yes			Yes									KPMG
41 Endocare Inc.	ENDO	50	Yes	Yes	Yes										Ernst & Young
42 Engineered Support System	EASI	N/A		Yes	Yes										PricewaterhouseCoopers
43 ePlus Inc.	PLUS	78	Yes						Yes	Yes					Deloitte & Touche
44 Equinix Inc.	EQIX	1,672	Yes	Yes	Yes	Yes				Yes					PricewaterhouseCoopers
45 F5 Networks Inc.	FFIV	1,690	Yes	Yes	Yes	Yes			Yes	Yes					PricewaterhouseCoopers
46 First American Corp.	FAF	3,805	Yes							Yes			1994		PricewaterhouseCoopers
47 Foundry Networks Inc.	FDRY	1,516	Yes	Yes	Yes					Yes		Yes			Ernst & Young
48 Fresenius Medical Care AG KGaA	FMS	12,552			Yes										KPMG
49 Greater Bay Bancorp	GBBK	1,453	Yes									Yes			PricewaterhouseCoopers
50 HCC Insurance Holdings Inc.	HCC	3,444	Yes	Yes						Yes					PricewaterhouseCoopers
51 Home Depot Inc.	HD	71,119	Yes	Yes		Yes							1994		KPMG
52 Integrated Silicon Solution Inc.	ISSI	178	Yes	Yes						Yes					Ernst & Young
53 Intuit Inc.	INTU	10,630	Yes	Yes	Yes									Yes	Ernst & Young
54 j2 Global Communications Inc.	JCOM	1,123	Yes							Yes					Deloitte & Touche
55 Jabil Circuit Inc.	JBL	5,373	Yes	Yes	Yes	Yes						Yes			KPMG
56 Juniper Networks Inc.	JNPR	7,632	Yes		Yes	Yes			Yes	Yes		Yes			Ernst & Young
57 KB Home	KBH	3,821	Yes	Yes											Ernst & Young
58 Keithley Instruments Inc.	KEI	189	Yes			Yes						Yes			PricewaterhouseCoopers
59 Keryx Biopharmaceuticals Inc.	KERX	457	Yes												KPMG
60 Key Energy Services Inc.	KEGS	1,875	Yes						Yes	Yes					KPMG
61 KLA-Tencor Corp.	KLAC	8,517	Yes	Yes	Yes	Yes							1994, 2004	Yes	PricewaterhouseCoopers
62 Knobias Inc.	KNBS	4	Yes						Yes	Yes					Russell Bedford Stefanou Mirchandani
63 Kos Pharmaceuticals Inc.	KOSP	2,167	Yes	Yes					Yes	Yes					Ernst & Young
64 L-3 Communications Holdings Inc.	LLL	8,490	Yes												PricewaterhouseCoopers
65 Linear Technology Corp.	LLTC	9,731		Yes	Yes	Yes						Yes			Ernst & Young

Source: Glass Lewis, Wall Street Journal, Bloomberg, Reuters, Stanford Securities Class Action Clearinghouse, FASB, Analyst's Accounting Observer, company filings. See legend for column explanations.

Company	Ticker	Market value ($M)	Internal	SEC	DoJ	Share-holder suits	Criminal cases	Executive or director departures	Restatements	Late filings	Material weaknesses	Accel. vesting	FASB comment letters	IESOC	Auditor
66 Macrovision Corp.	MVSN	1,134	Yes	Yes	Yes								2004		KPMG
67 Marvell Technology Group Ltd.	MRVL	10,888	Yes	Yes	Yes	Yes									PricewaterhouseCoopers
68 Maxim Integrated Products Inc.	MXIM	8,917	Yes	Yes	Yes	Yes									Deloitte & Touche
69 McAfee Inc.	MFE	3,348	Yes	Yes	Yes			Yes	Yes	Yes					Deloitte & Touche
70 MDC Partners Inc.	MDCA	195	Yes												KPMG
71 Meade Instruments Corp.	MEAD	48	Yes	Yes					Yes	Yes					Moss Adams
72 Medarex Inc.	MEDX	1,055	Yes	Yes	Yes	Yes			Yes	Yes					Ernst & Young
73 Mercury Interactive Corp.	MERQ	4,356	Yes	Yes		Yes		Yes	Yes	Yes	Yes				PricewaterhouseCoopers
74 Michaels Stores Inc.	MIK	5,646	Yes	Yes	Yes	Yes				Yes					Ernst & Young
75 Microislet Inc.	MII	70	Yes							Yes	Yes				Deloitte & Touche
76 Microtune Inc.	TUNE	296	Yes							Yes					Ernst & Young
77 MIPS Technologies Inc.	MIPS	281	Yes												Ernst & Young
78 Moldflow Corp.	MFLO	127	Yes												Grant Thornton
79 Molex Inc.	MOLX	6,367	Yes			Yes									Ernst & Young
80 Monster Worldwide Inc.	MNST	5,213	Yes	Yes	Yes	Yes			Yes	Yes		Yes	2004		BDO Seidman
81 M-Systems Flash Disk Pioneers Ltd.	FLSH	1,357	Yes	Yes		Yes				Yes	Yes				Kost, Forer, Gabbay & Kasierer
82 Newpark Resources Inc.	NR	486	Yes			Yes		Yes	Yes						Ernst & Young
83 Novell Inc.	NOVL	2,372	Yes										1994		PricewaterhouseCoopers
84 Novellus Systems Inc.	NVLS	3,171	Yes									Yes			Ernst & Young
85 NVIDIA Corp.	NVDA	8,996	Yes												KPMG
86 NYFIX Inc.	NYFX	140	Yes	Yes	Yes	Yes			Yes	Yes	Yes				Friedman
87 Omnicell Inc.	OMCL	459	Yes						Yes						Ernst & Young
88 Openwave Systems Inc.	OPWV	642		Yes	Yes	Yes									KPMG
89 Pediatrix Medical Group Inc.	PDX	2,085	Yes							Yes					PricewaterhouseCoopers
90 PMC-Sierra Inc.	PMCS	1,165	Yes						Yes	Yes	Yes	Yes			Deloitte & Touche
91 Pool Corp.	POOL	2,029	Yes												Ernst & Young
92 Power Integrations Inc.	POWI	504	Yes	Yes	Yes			Yes	Yes	Yes	Yes				Deloitte & Touche
93 Progress Software Corp.	PRGS	970	Yes	Yes		Yes			Yes	Yes					Deloitte & Touche
94 Quest Software Inc.	QSFT	1,287	Yes	Yes					Yes	Yes					Deloitte & Touche
95 QuickLogic Corp.	QUIK	82	Yes	Yes						Yes		Yes	2004		PricewaterhouseCoopers
96 Rambus Inc.	RMBS	1,168	Yes			Yes		Yes	Yes	Yes	Yes				PricewaterhouseCoopers
97 Redback Networks Inc.	RBAK	1,286	Yes	Yes	Yes					Yes					PricewaterhouseCoopers
98 Renal Care Group Inc.	RCI	N/A			Yes										Ernst & Young
99 Restoration Hardware Inc.	RSTO	243	Yes												Deloitte & Touche
100 RSA Security Inc.	RSAS	2,095		Yes	Yes	Yes						Yes			Deloitte & Touche

Source: Glass Lewis, Wall Street Journal, Bloomberg, Reuters, Stanford Securities Class Action Clearinghouse, FASB, Analyst's Accounting Observer, company filings. See legend for column explanations.

Company	Ticker	Market value ($M)	Internal	SEC	DoJ	Shareholder suits	Criminal cases	Executive or director departures	Restatements	Late filings	Material weaknesses	Accel. vesting	FASB comment letters	IESOC	Auditor
101 SafeNet Inc.	SFNT	421	Yes	Yes	Yes	Yes			Yes	Yes					Ernst & Young
102 Sanmina-SCI Corp.	SANM	1,732	Yes	Yes						Yes		Yes			KPMG
103 Sapient Corp.	SAPE	603	Yes							Yes					PricewaterhouseCoopers
104 Semtech Corp.	SMTC	853	Yes	Yes	Yes	Yes			Yes	Yes					Ernst & Young
105 Sepracor Inc.	SEPR	4,928	Yes	Yes					Yes	Yes					PricewaterhouseCoopers
106 Sigma Designs Inc.	SIGM	215	Yes	Yes		Yes					Yes				Grant Thornton
107 Skins Inc.	SKNN	40	Yes						Yes						Mahoney Cohen & Co.
108 Sonus Networks Inc.	SONS	1,159	Yes							Yes		Yes			Deloitte & Touche
109 SPSS Inc.	SPSS	452	Yes								Yes				Grant Thornton
110 Stolt-Nielsen S.A.	SNSA	1,543	Yes	Yes							Yes				Deloitte & Touche
111 Sunrise Telecom Inc.	SRTI	120	Yes												KPMG
112 Sycamore Networks Inc.	SCMR	1,012	Yes	Yes	Yes	Yes			Yes	Yes	Yes				PricewaterhouseCoopers
113 Sysview Technology Inc.	SYVT	25	Yes						Yes						Clancy & Co.
114 Take-Two Interactive Software Inc.	TTWO	838	Yes	Yes		Yes									Ernst & Young
115 Tetra Tech Inc.	TTEK	1,007	Yes							Yes	Yes	Yes			Deloitte & Touche
116 THQ Inc.	THQI	1,644	Yes	Yes		Yes									Deloitte & Touche
117 Trident Microsystems	TRID	996	Yes	Yes	Yes	Yes									PricewaterhouseCoopers
118 Ulticom Inc.	ULCM	434	Yes			Yes				Yes					Deloitte & Touche
119 UnitedHealth Group Inc.	UNH	64,217	Yes	Yes	Yes	Yes				Yes					Deloitte & Touche
120 Verint Systems Inc.	VRNT	940	Yes	Yes				Yes		Yes					Deloitte & Touche
121 VeriSign Inc.	VRSN	4,321	Yes	Yes	Yes					Yes		Yes	2004	Yes	KPMG
122 ViaSat Inc.	VSAT	768	Yes							Yes					PricewaterhouseCoopers
123 Vitesse Semiconductor	VTSS	196	Yes	Yes	Yes	Yes		Yes	Yes	Yes		Yes			KPMG
124 Western Digital Corp.	WDC	3,710	Yes											Yes	KPMG
125 Wind River Systems Inc.	WIND	784	Yes												PricewaterhouseCoopers
126 Witness Systems Inc.	WITS	505	Yes			Yes			Yes	Yes					KPMG
127 Xilinx Inc.	XLNX	7,018	Yes	Yes		Yes				Yes			1994, 2004	Yes	Ernst & Young
128 Zoran Corp.	ZRAN	726	Yes	Yes	Yes	Yes				Yes					PricewaterhouseCoopers

Source: Glass Lewis, Wall Street Journal, Bloomberg, Reuters, Stanford Securities Class Action Clearinghouse, FASB, Analyst's Accounting Observer, company filings. See legend for column explanations.

Legend: Market value – company's market capitalization as of Aug. 15, 2006. Internal – company announced an internal review. SEC – company is part of a Securities and Exchange Commission informal inquiry or investigation. DoJ – company received a subpoena from U.S. attorney. Shareholder suits – company was named a defendant in shareholder litigation. Criminal cases – criminal charges were filed against company executives. Executive or director departures – company officers or directors resigned or were fired in connection with the company's stock-option investigation. Restatements – company announced it will restate historical financial statements to correct stock-based compensation expense and filed an 8-K, Item 4.02, for non-reliance on previously issued financial statements. Late filings – company delayed at least one annual or quarterly filing in connection with its stock-option review. Material weaknesses – company disclosed it has a material weakness in its internal controls related to accounting for stock options. Accel. vesting – company accelerated the vesting of its stock options before FAS 123R went into effect. FASB comment letters – company sent a comment letter to the Financial Accounting Standards Board that opposed either the original FAS 123 exposure draft (1994), or the Share-Based Payment (a.k.a. FAS 123R) exposure draft (2004), both of which proposed the expensing of employee stock options. IESOC – company was a member of the International Employee Stock Option Coalition, a group of companies and organizations that opposed FAS 123 and the expensing of stock

Appendix B

Sample Form 4 Disclosures

SEC Form 4

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	January 31, 2008
Estimated average burden hours per response	0.5

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

1. Name and Address of Reporting Person* CIAMPI MARIO (Last) (First) (Middle) 915 SECAUCUS ROAD (Street) SECAUCUS NJ 07094 (City) (State) (Zip)	2. Issuer Name and Ticker or Trading Symbol CHILDRENS PLACE RETAIL STORES INC [PLCE] 3. Date of Earliest Transaction (Month/Day/Year) 04/29/2005 4. If Amendment, Date of Original Filed (Month/Day/Year)	5. Relationship of Reporting Person(s) to Issuer (Check all applicable) Director — 10% Owner X Officer (give title below) — Other (specify below) Sr. VP 6. Individual or Joint/Group Filing (Check Applicable Line) X Form filed by One Reporting Person Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)	4. Securities Acquired (A) or Disposed Of (D) (Instr. 3, 4 and 5)	5. Amount of Securities Beneficially Owned	6. Ownership Form: Direct (D) or	7. Nature of Indirect Beneficial Ownership

			Code	V	Amount	(A) or (D)	Price			

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Securities Underlying Derivative Security (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of derivative Securities Beneficially Owned Following Reported Transaction(s) (Instr. 4)	10. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Stock Option (right to buy)	$37.66	04/29/2005		A			80,000	04/28/2006 (1)	04/29/2015	Common Stock	80,000	$37.66	219,000 (2)	D	

Explanation of Responses:

1. Exercisable cumulatively at the rate of 25% on April 28, 2006 and 25% each year thereafter.

2. Includes (i) 86,600 employee stock options currently exercisable and (ii) 132,400 employee stock options exercisable over the next 4 years.

Remarks:

Mario Ciampi	05/20/2005
** Signature of Reporting Person	Date

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

* If the form is filed by more than one reporting person, *see* Instruction 4 (b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.

SEC Form 4

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	January 31, 2008
Estimated average burden hours per response	0.5

1. Name and Address of Reporting Person* DABAH EZRA (Last) (First) (Middle) 915 SECAUCUS ROAD	2. Issuer Name and Ticker or Trading Symbol CHILDRENS PLACE RETAIL STORES INC [PLCE]	5. Relationship of Reporting Person(s) to Issuer (Check all applicable) Director X 10% Owner Officer (give title below) Other (specify below)
	3. Date of Earliest Transaction (Month/Day/Year) 04/29/2005	
(Street) SECAUCUS NJ 07094 (City) (State) (Zip)	4. If Amendment, Date of Original Filed (Month/Day/Year)	6. Individual or Joint/Group Filing (Check Applicable Line) X Form filed by One Reporting Person Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)	4. Securities Acquired (A) or Disposed Of (D) (Instr. 3, 4 and 5)	5. Amount of Securities Beneficially Owned	6. Ownership Form: Direct (D) or	7. Nature of Indirect Beneficial Ownership

				Code	V	Amount	(A) or (D)	Price				

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Securities Underlying Derivative Security (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of derivative Securities Beneficially Owned Following Reported Transaction(s) (Instr. 4)	10. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Stock Options (right to buy)	$41.42	04/29/2005		A		85,000		04/28/2006 (1)	04/29/2010	Common Stock	85,000	$41.42	284,660 (2)	I	Spouse

Explanation of Responses:

1. Exercisable cumulatively at the rate of 25% on April 28, 2006 and 25% each year thereafter.

2. Consists of 99,660 employee stock options currently exercisable and 185,000 employee stock options exercisable over the next four years.

Remarks:

Renee Dabah	05/20/2005
** Signature of Reporting Person	Date

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

* If the form is filed by more than one reporting person, *see* Instruction 4 (b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.

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SEC Form 4

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0287
Expires:	January 31, 2008
Estimated average burden hours per response	0.5

☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

1. Name and Address of Reporting Person*	2. Issuer Name and Ticker or Trading Symbol	5. Relationship of Reporting Person(s) to Issuer (Check all applicable)
DABAH EZRA (Last) (First) (Middle) 915 SECAUCUS ROAD	CHILDRENS PLACE RETAIL STORES INC [PLCE] 3. Date of Earliest Transaction (Month/Day/Year) 04/29/2005	X Director X 10% Owner X Officer (give title below) Other (specify below) Chairman and CEO
(Street) SECAUCUS NJ 07094 (City) (State) (Zip)	4. If Amendment, Date of Original Filed (Month/Day/Year)	6. Individual or Joint/Group Filing (Check Applicable Line) X Form filed by One Reporting Person Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)	4. Securities Acquired (A) or Disposed Of (D) (Instr. 3, 4 and 5)	5. Amount of Securities Beneficially Owned	6. Ownership Form: Direct (D) or	7. Nature of Indirect Beneficial Ownership

			Code	V	Amount	(A) or (D)	Price			

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Securities Underlying Derivative Security (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of derivative Securities Beneficially Owned Following Reported Transaction(s) (Instr. 4)	10. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Stock Options (right to buy)	$41.42	04/29/2005		A		85,000		04/28/2006 (1)	04/29/2010	Common Stock	85,000	$41.42	284,660 (2)	D	

Explanation of Responses:

1. Exercisable cumulatively at the rate of 25% on April 28, 2006 and 25% each year thereafter.

2. Consists of 99,660 employee stock options currently exercisable and 185,000 employee stock options exercisable over the next 4 years.

Remarks:

Ezra Dabah — 05/20/2005

** Signature of Reporting Person — Date

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

* If the form is filed by more than one reporting person, *see* Instruction 4 (b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

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			Code	V	Amount	(A) or (D)	Price			

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Securities Underlying Derivative Security (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of derivative Securities Beneficially Owned Following Reported Transaction(s) (Instr. 4)	10. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Stock Options (right to buy)	$37.66	04/29/2005		A		85,000		04/28/2006 (1)	04/29/2015	Common Stock	85,000	$37.66	385,000 (2)	D	

Explanation of Responses:

1. Exercisable cumulatively at the rate of 25% on April 28, 2006 and 25% each year thereafter.

2. Consists of 50,000 employee stock options currently exercisable and 335,000 employee stock options exercisable over the next 4 years.

Remarks:

Neal Goldberg	05/20/2005
** Signature of Reporting Person	Date

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

* If the form is filed by more than one reporting person, *see* Instruction 4 (b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

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SEC Form 4

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

OMB APPROVAL	
OMB Number:	3235-0287
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☐ Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

1. Name and Address of Reporting Person* GOLDBERG NEAL (Last) (First) (Middle) 915 SECAUCUS ROAD	2. Issuer Name and Ticker or Trading Symbol CHILDRENS PLACE RETAIL STORES INC [PLCE] 3. Date of Earliest Transaction (Month/Day/Year) 04/21/2005	5. Relationship of Reporting Person(s) to Issuer (Check all applicable) Director — 10% Owner X Officer (give title below) — Other (specify below) President
(Street) SECAUCUS NJ 07094 (City) (State) (Zip)	4. If Amendment, Date of Original Filed (Month/Day/Year) 04/25/2005	6. Individual or Joint/Group Filing (Check Applicable Line) X Form filed by One Reporting Person Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)	4. Securities Acquired (A) or Disposed Of (D) (Instr. 3, 4 and 5)	5. Amount of Securities Beneficially Owned	6. Ownership Form: Direct (D) or	7. Nature of Indirect Beneficial Ownership

			Code	V	Amount	(A) or (D)	Price			

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Securities Underlying Derivative Security (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Number of derivative Securities Beneficially Owned Following Reported Transaction(s) (Instr. 4)	10. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	11. Nature of Indirect Beneficial Ownership (Instr. 4)
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares				
Employee Stock Options (right to buy)	$40.65	04/21/2005		A		50,000		04/30/2005 (1)	01/21/2014	Common Stock	50,000	$40.65	300,000 (2)	D	

Explanation of Responses:

1. Exercisable cumulatively at the rate of 20% on October 31, 2005, 20% on January 31, 2006 and 20% on each subsequent January 31st thereafter.

2. Consists of 50,000 employee stock options currently exercisable and 250,000 employee stock options exercisable over the next 4 years.

Remarks:

Neal Goldberg — 05/20/2005

** Signature of Reporting Person — Date

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

* If the form is filed by more than one reporting person, *see* Instruction 4 (b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

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Appendix C

Proxy Disclosure of Repeated Late Form 4 Filings

DEF 14A 1 w22697def14a.htm SAFENET, INC. DEFINITIVE PROXY STATEMENT

SCHEDULE 14A — INFORMATION REQUIRED IN PROXY STATEMENT

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant ☑

Filed by a Party other than the Registrant ☐

Check the appropriate box:

☐ Preliminary Proxy Statement

☐ Confidential, for use of the Commission Only (as permitted by Rule 14a-6(e)(2))

☑ Definitive Proxy Statement

☐ Definitive Additional Materials

☐ Soliciting Material Pursuant to § 240.14a-11(c) or § 240.14a-12

SAFENET, INC.

(Name of Registrant as Specified in its Charter)

(Name of Person(s) Filing Proxy Statement if Other Than Registrant)

Compliance with Section 16(a) of the Exchange Act

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's executive officers and directors, and persons who own more than 10% of the outstanding shares of Common Stock, to file reports of ownership and changes in ownership with the Securities and Exchange Commission. Based solely on a review of the copies of such reports furnished to the Company and written representations from the executive officers and directors, the Company is aware of the following instances of noncompliance or late compliance with such filings during the fiscal years ended December 31, 2005, 2004, 2003 and 2002, respectively, by its executive officers and directors:

- As first reported in the Company's Form 10-K/A filed with the Securities and Exchange Commission on April 11, 2006, with respect to the fiscal year ended December 31, 2005, Messrs. Brooks, Harrison and Lesem and Ms. Argo each failed to file two Forms 4 during the year to report two separate grants of stock options, and Messrs. Clark, Hunt, Money, Straub, Thaw, Caputo, Mueller (a former executive officer of the Company) and Fedde each failed to file one Form 4 during the year to report one grant of stock options;

- With respect to the fiscal year ended December 31, 2004, Mr. Harrison failed to file two Forms 4 during the year to report two separate grants of stock options, and Messrs. Brooks, Clark, Hunt, Money, Straub, Thaw, Caputo, Fedde and Mueller and Ms. Argo each failed to file one Form 4 during the year to report one grant of stock options;

- With respect to the fiscal year ended December 31, 2003, Messrs. Brooks, Clark, Harrison, Hunt, Thaw, Fedde and Ms. Argo each failed to file two Forms 4 during the year to report two separate grants of stock options, and Messrs. Caputo, Money and Straub each failed to file one Form 4 during the year to report one grant of stock options; and

- With respect to the fiscal year ended December 31, 2002, Mr. Caputo failed to file one Form 4 to report one grant of stock options.

Each of the transactions listed above was reported on a Form 5 filed after the end of each of the respective fiscal years rather than a Form 4, as was required beginning August 29, 2002 pursuant to the Sarbanes-Oxley Act of 2002. The Company is aware of compliant Forms 4 reports during this period being filed for transactions involving sales and purchases of the Company's stock, as well as stock option exercises. The Company is continuing to review prior filings under Section 16(a) of the Exchange Act for completeness.

Legal Proceedings

On May 18, 2006, the Company announced that it has received a subpoena from the office of the United States Attorney for the Southern District of New York relating to the Company's granting of stock options. The Company also announced that it has received an informal inquiry from the Securities and Exchange Commission requesting information relating to stock option grants to directors and officers of the Company, as well as information relating to certain accounting policies and practices. The Company is actively engaged in responding to these requests and is cooperating with both offices.

On and after May 31, 2006, individuals claiming to be shareholders of the Company filed multiple derivative complaints in the Circuit Court for Harford County, Maryland, against current and former officers and directors of the Company, as well as the Company as a nominal defendant. The complaints allege state law claims for breach of fiduciary duty and unjust enrichment arising from alleged backdating of stock option grants. On and after June 6,

9

2006, individuals claiming to be shareholders of the Company filed multiple derivative complaints in the United States District Court for the District of Maryland, purportedly on behalf of the Company, against the current directors and certain current and former officers of the Company, as well as the Company as a nominal defendant. The complaints allege, among other things, claims for breach of fiduciary duties and unjust enrichment and claims under Section 304 of the Sarbanes-Oxley Act of 2002 arising from alleged backdating of stock option grants and alleged dissemination of misleading and inaccurate information through public statements, including filings with the Securities and Exchange Commission. The Board of Directors has directed a special committee of the board to investigate these allegations. This special committee has retained independent counsel and has the authority to retain such other advisers as it deems appropriate to assist in the investigation.

In addition, the Company has also received a letter from a law firm, allegedly on behalf of an unidentified shareholder, demanding that the Board of Directors recover short swing profits alleged to be made by officers and directors in alleged violations of Section 16(b) of the Securities Exchange Act of 1934, as amended. The special committee also will investigate these allegations.

PREPARED STATEMENT OF ERIK LIE

ASSOCIATE PROFESSOR OF FINANCE, UNIVERSITY OF IOWA

SEPTEMBER 6, 2006

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee:

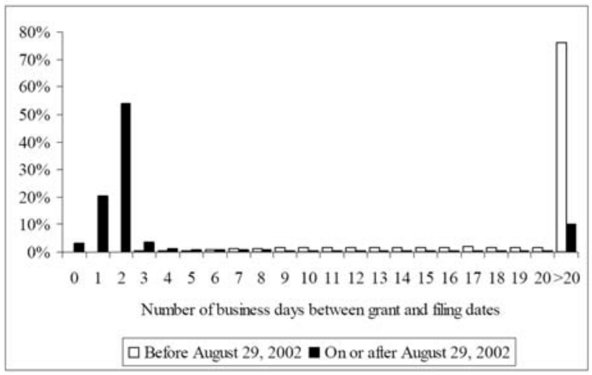
Thank you for inviting me to testify today about stock options backdating. In theory, stock options can be used to motivate executives and other employees to create value for shareholders. However, they have also been used to (i) conceal true compensation expenses, (ii) cheat on corporate taxes, and (iii) siphon money away from shareholders to option recipients. I will take this opportunity to offer some background on stock options and stock option grants, describe the practice of backdating, and make some recommendations for the future.

BACKGROUND ON STOCK OPTIONS AND STOCK OPTION GRANTS

Let me first provide some background on and mention some key aspects of executive stock options and option grants.

- A stock option gives its owner the right to buy the stock of the company in the future.
- Stock options are granted to executives at various intervals. It is common to grant options once a year, though it is also possible for executives not to be granted options in a year or to be granted options numerous times in a year. In most cases, there is no fixed schedule to these grants, meaning that they do not occur on the same date (e.g., on July 1) in consecutive years.

- Before August 29, 2002, executive option grants had to be filed anywhere from 10 business days to more than a year after the grant, depending on (i) when a grant occurred within a calendar month and fiscal year and (ii) whether a Form 4 or Form 5 was used when filing the grants with the SEC. Under the current regulations that took effect on August 29, 2002 as part of the Sarbanes-Oxley Act, option grants to executives have to be filed with the Securities and Exchange Commission (SEC) within two business days. Distributions of the number of days between the official grant date and the filing date based on a sample of about 40,000 grants to top executives between 1996 and 2005 are given in the graph below. The new filing requirement dramatically reduced the lag between the grant date and the filing date. Importantly, about 22% of grants since August 29, 2002 were filed late, and almost 10% were filed at least one month late.



- Most options granted to executives expire after exactly 10 years.
- The price at which the stock can be bought is determined at the time of the grant and generally does not change. It is called the "exercise price" or the "strike price."
- Most executive stock options are granted "at-the-money," i.e., the exercise price is set to equal the stock price on the day of the grant. ("In-the-money" means that the exercise price is below the stock price, and "out-of-the-money" means that the exercise price is above the stock price.)
- In a sample of 40,000 grants from 1996 to 2005, the exercise price matches the closing price on the grant day in 50% of the cases and the closing price on the day before the grant day in 12% of the cases.
- There are several reasons why options are granted at-the-money:
  - Accounting Principles Board (APB) Opinion No. 25, which was phased out in 2005, allowed companies to expense options according to the intrinsic value method, whereby the expense equals the difference between the fair value of the underlying stock and the exercise price of the option. Under this rule, at-the-money options did not have to be charged against reported earnings. (Under FAS 123R, which replaced APB 25, companies have to expense the fair market value of the options at the time of the grant.)
  - Unlike in-the-money grants, at-the-money grants qualify as performance-based compensation. As such, at-the-money grants receive favorable tax treatment under Section 162(m) of the Internal Revenue Code, which limits the deductibility of nonperformance-based compensation for tax purposes to one million dollars per executive.
  - Incentive stock options (ISOs), which are often a part of broad-based option plans that could qualify for more favorable tax treatment than non-qualified options at the individual level, cannot be granted in-the-money. Note, however, that most options granted to executives are non-qualified options (NQOs), and not ISOs, as ISOs are limited to a value of $100,000 per employee per calendar year and also count as income in the determination of the Alternative Minimum Tax (AMT).
  - At-the-money grants might be perceived as a better incentive mechanism than in-the-money options, because executives are only rewarded if the stock price increases.
- The practice of granting options at-the-money provides the incentives to time the grant to occur on a day when the stock price was particularly low and/or

to manipulate the information flow around the grant date. (Note that these incentives would be present for in-the-money and out-of-the money grants also, provided that the exercise price is a function of the stock price, e.g., 90% or 110% of the stock price.)

- Some potential strategies that might be used to inflate the value of option grants include the following:
  - *Spring-loading/Bullet-dodging:* The terms "spring-loading" and "bullet-dodging" refer to the practices of timing option grants to take place before expected good news or after expected bad news, respectively. They have also been referred to as "forward dating."
  - *Manipulation of the information flow:* This refers to the practice of timing corporate announcements relative to known future option grant dates. For example, if a firm will soon announce a share repurchase plan that is expected to raise the stock price, this announcement might be postponed until after the option grant.
  - *Backdating:* This refers to the practice of cherry-picking a date from the past when the stock price was relatively low to be the official grant date.

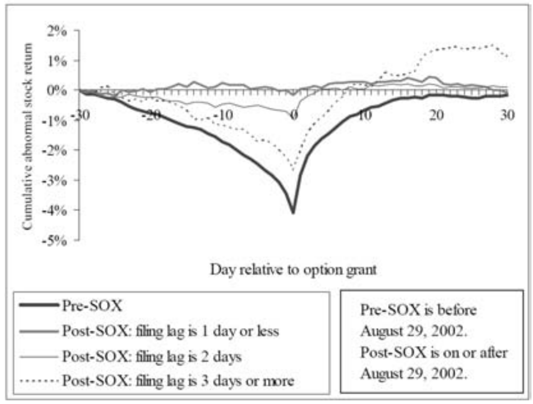
RESEARCH ON OPTION GRANT TIMING

In a 1997 study entitled "Good timing: CEO stock option awards and company news announcements," David Yermack of New York University reported that the average abnormal stock return during the months after option grants to CEOs between 1992 and 1994 exceeds 2%, which he interpreted as evidence that the grants are timed to occur before anticipated stock price increases (i.e., spring-loading).

In a 2000 study entitled "CEO stock option awards and the timing of corporate voluntary disclosures," David Aboody of UCLA and Ron Kasznik of Stanford University reported that the average abnormal stock return is positive even for a subsample of grants between 1992 and 1996 that appear to be scheduled. They interpreted this as evidence that the information flow around grants is manipulated.

In my 2005 study entitled "On the timing of CEO stock option awards," I documented negative abnormal stock returns before and positive returns after CEO option grants between 1992 and 2002, and these trends intensified over time. I further reported that the portion of the stock returns that is predicted by overall market factors exhibits a similar pattern, prompting my conclusion that "unless executives have an informational advantage that allows them to develop superior forecasts regarding the future market movements that drive these predicted returns, the results suggest that the official grant date must have been set retroactively" (p. 811).

In a soon-to-be-published study entitled "Does backdating explain the stock price pattern around executive stock option grants?" that I coauthored with Randy Heron of Indiana University, we found further evidence in support of my earlier backdating argument. As noted earlier, a provision in Sarbanes-Oxley reduces the SEC filing requirement for new option grants to two days from the earlier requirements that allowed executives to report grants up to several months after the grant date. To the extent that companies comply with this new requirement, backdating should be greatly curbed. Thus, if backdating explains the stock price pattern around option grants, the price pattern should diminish following the new requirements. Indeed, we found that the stock price pattern is much weaker since the new reporting requirements took effect. Any remaining pattern is concentrated on the couple of days between the reported grant date and the filing date (when backdating still might work), and for longer periods for the minority of grants that violate the two-day reporting requirements. I replicated these results in the figure below using a sample of about 40,000 grants to top executives during the period 1996–2005. We interpreted the findings as strong evidence that backdating explains most of the abnormal price pattern around option grants.



In an unpublished study entitled "What fraction of stock option grants to top executives have been backdated or manipulated?" Randy Heron and I used a sample of 39,888 grants to top executives across 7,774 companies between 1996 and 2005 to estimate the following:

- 14% of all grants to top executives dated between 1996 and 2005 were backdated or otherwise manipulated.
- 23% of unscheduled, at-the-money grants to top executives dated between 1996 and August 2002 were backdated or otherwise manipulated.
- This fraction was more than halved to 10% as a result of the new two-day reporting requirement that took effect in August 2002.
  - Among the minority of unscheduled, at-the-money grants after August 2002 that were filed late (i.e., more than two business days after the purported grant dates), 20% were backdated or otherwise manipulated.
  - Among the majority of unscheduled, at-the-money grants after August 2002 that were filed on time, 7% were backdated or otherwise manipulated. (The benefit of backdating is naturally greatly reduced in such cases.)
- The prevalence of backdating differs across firm characteristics; backdating is more common among—
  - tech firms,
  - small and medium firms (i.e., those with a market capitalization less than $1 billion), and
  - firms with high stock price volatility.
- The auditing firm is only modestly associated with the incidence of backdating.
  - PricewaterhouseCoopers is associated with a slightly lower fraction of backdated grants after controlling for other factors.
  - Non-big-five auditing firms are associated with a higher fraction of both late filings and unscheduled grants, which appear to result in more backdating.
- 29% of firms that granted options to top executives between 1996 and 2005 manipulated one or more of these grants in some fashion.

IS OPTION GRANT TIMING ILLEGAL?

There is an ongoing debate regarding whether spring-loading and bullet-dodging are illegal. These practices have been compared to insider trading of stock. The debate hinges on the definition of the "harmed party." In regular insider trading cases, one party in the transaction possesses inside information that the other party (the harmed party) does not possess. In cases of option grants, some have argued that both parties, i.e., the option recipient and the Board of Directors of the firm that grants the options, have access to the same inside information, so it is not the case that the option recipient exploits an informational advantage. The other point of view is that insiders, with the consent of the Board of Directors, are using their informational advantage to extract additional compensation from the firm's owners (shareholders). Under this viewpoint, the harmed party would be the firm's existing shareholders, who do not possess the same information, and whose ownership value is reduced to a greater degree than would otherwise be the case.

Backdating is less ambiguous. If options purported to be at-the-money on the backdated grant date were in-the-money on the actual grant date (which should be

the measurement date for financial and tax reporting purposes) and not properly accounted for, then

- the firm's reported earnings were too high according to the accounting regulations (under both APB 25 and FAS 123R),
- the firm's taxes might have been too low (due to IRC § 162(m), and because the deductible spread between the exercise price and the stock price at the time of the actual option exercises is artificially inflated),
- if the options are ISOs, one of their requirements for their favored tax-status has been violated, and
- any requirement in the option plan that the options should be granted at the fair market value is violated.

In addition, to implement the backdating strategy, documents might have been forged, which is a federal offense.

Conclusion

Backdating of option grants was a pervasive practice among publicly traded corporations in the U.S. in the late 1990s and the beginning of this century. My own research suggests that spring-loading, bullet-dodging, and manipulation of the information flow was either significantly less prevalent or less successful in the aggregate in producing immediate gains for the option recipients during the same period.

The problem of backdating can be eliminated by requiring grants to be filed electronically with the SEC on the same day that they are granted. Given that (i) the form for filing this information is very simple and (ii) the forms can be filed online, this is a reasonable requirement, and, in fact, some grants are already filed on the grant date. Of course, this requirement has to be strictly enforced with appropriate penalties for any violation, such that the frequency of late filing that is evident for the last few years is greatly reduced.

As the problem of backdating is eliminated, the problems of spring-loading, bullet-dodging and manipulation of the information flow might become more prominent. Thus, it is critical to clarify whether these alternative strategies are legal. If so, restrictions to minimize their occurrence should be developed. In particular, options should not be granted near major corporate announcements. Further, there should be timely and complete disclosure of grants.

Finally, to eliminate timing relative to recent stock prices, the benchmark stock price should be the price on the grant date. For example, if the options are granted at-the-money, the exercise price should be set to equal the stock price on the grant day rather than the stock price on the prior day, which is a fairly common practice (see earlier statistics). This eliminates the possibility that options are granted on a day when the price has increased significantly but the prior day's lower price is used for contracting purposes.

PREPARED STATEMENT OF KURT SCHACHT

MANAGING DIRECTOR, CFA CENTRE FOR FINANCIAL MARKET INTEGRITY

SEPTEMBER 6, 2006

Introduction

I am Kurt Schacht, the Executive Director of the CFA Centre for Financial Market Integrity, the advocacy arm of CFA Institute. I would like to thank Senator Shelby, Senator Sarbanes and other members of this committee for the opportunity to speak to you today on the topic of stock option practices, in particular backdating of option grants. This issue raises important shareholder concerns and we are supportive of your committee taking a closer look, as well as the work of Chairman Cox and the Securities and Exchange Commission (SEC) to investigate alleged abuses.

First, some background about CFA Centre and its parent organization, CFA Institute. CFA Institute is a non-profit professional membership organization with over 84,000 members in 128 countries. Its mission is to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the CFA examination and awards the CFA designation, a designation that I share with nearly 68,000 investment professionals worldwide. I direct the advocacy efforts of CFA Institute through the newly created CFA Centre for Financial Market Integrity, which develops research, education projects and promotes ethical standards within the investment industry.

The CFA Centre Perspective: Options Backdating

Our organization approaches this topic primarily as an investor advocate with a focus on protecting shareholder interests and ensuring accurate and transparent financial reporting. We were an early voice for the SEC to amend its newly released executive compensation disclosures to deal with the practice of option backdating and its companion practice of "spring-loading." Both have been prevalent for years and have generally gone unnoticed. In some cases, these practices have been purposefully hidden from shareholder view. The recent focus by various academic studies and the resulting regulatory investigations into the backdating practices have confirmed what is at best, the latest executive compensation controversy and at worst, a growing financial reporting scandal.

Historically, the rationale for granting stock options to executives and other employees was to align their interests with shareowners, and to provide an incentive for them to enhance shareholder value. Several commentators have suggested that even backdated options continue to have such attributes and that the backdating controversy is overblown with politics and rhetoric. They would have us believe it is a "victimless" infraction. In our view, the practices of backdating and spring-loading are unethical manipulations of the option granting process designed to increase employees' compensation to the detriment of shareowners. These practices have been secretive and have placed numerous companies at significant financial and leadership risk. As with most company scandals resulting in significant cost and uncertainty, it is the public shareowners that fall victim.

We remain concerned about the ultimate scope of the backdating problem. Specifically, is this activity limited to the 100–plus firms under formal investigation or does it extend to a much larger group? For a variety of reasons, including the recent public outrage, the requirements of FASB Statement 123R and APB Opinion 25, the Sarbanes-Oxley requirement to file accelerated Form 4's and the new SEC compensation disclosure rules, backdating itself may be yesterday's problem. However, the degree of necessary "clean-up" due to the vast number of companies and the size of stock options incentives in 1990–2002, seems to be unknown. It represents an overhang for individual companies for sure, but more problematic, it must not become a sequel to the lost confidence in financial reporting experienced earlier in this decade.

One mitigating factor may be that in recent months, the use of stock options has fallen out of favor due partly to the new option expensing rules. Whether we consider long term effects or short term effects of backdating and spring-loading, options use has become more rationalized. What this may signal however, is a need for further examination of the "replacement" for options, the practice of granting restricted stock. We should be certain that the gaming of grant dates or material information has not become part of the calculus for this now more favored type of stock incentive.

One final point of perspective relates to the ethical implications of backdating. This controversy comes at a time when executive compensation practices in general, are under intense scrutiny. These latest revelations concerning backdating and spring-loading certainly appear to be yet more practices intentionally conducted under the radar, for obvious reasons. It leaves many wondering about the respective standards and duties of officers and directors who approved of and even participated in some of these option granting irregularities. This is all the more troubling given that the practice appears to have continued after Sarbanes Oxley was passed in 2002 and suggests that at least some compensation and audit committee members may have been less than diligent in their duties.

Accounting and Auditing Practice—What Happened?

The accounting standard relating to stock option expenses that existed for many years before FASB Statement 123R was clear. APB Opinion 25 allowed companies to avoid a compensation expense only if certain criteria were met. Such criteria clearly included a requirement that the underlying stock price on the date of the grant must be equal to the exercise price of the options. Stated differently, the grant date price and the exercise price must match, in order to avoid the attendant compensation expense.

It is difficult to fashion an argument as to how this might ever happen in the context of backdating an option grant. Therefore, in nearly every case where an option grant date was backdated, a compensation expense was required to be recognized and reported in the company's income statement, unless it was deemed immaterial. As a result, nearly every company identified in the press as having backdating problems failed to properly record compensation expense for options and thereby filed financial statements that did not comply with the U.S. Generally Accepted Accounting Principles (GAAP) (again, unless the amount of expense was "immaterial").

Viewing this in the context of external auditor responsibilities, it remains unclear how this practice was repeatedly missed or worse, sanctioned. In some cases it may have been sloppiness, incompetence or both. In other cases it may have been an intentional act of concealment by the responsible managers. A number of the accounting firms have suggested that the client company's option documentation was typically taken at face value. Such documentation would generally indicate that the company had granted at-the-money, fixed-plan, employee options, when in fact they had not. This "papering" of the option transactions therefore appeared as though no compensation cost needed to be reported.

Generally, auditors thought that option practice was a low-risk (non cash) area and relied on the client company's records without attempting to verify if such records reflected what actually occurred. We think a clear lesson has now been established. However, we remain concerned whether auditors were actually complicit, turning a blind eye because of client pressures or because it seemed like "every one was doing it" (backdating). We have little doubt that auditors today will acknowledge that backdating typically failed to meet the criteria of APB Opinion 25, that is, recognition of zero expense only for at-the-money options.

It is now the case in over 100 countries around the world that follow either U.S. GAAP or International Accounting Standards rules, that backdating, without *expensing of the full fair value of the options,* would constitute a violation of accounting standards. Whether because of these new option expensing rules, Sarbanes Oxley, the public furor over backdating or some combination thereof, we must now expect that proper audit procedures would demand a closer look and verification of these options and restricted stock practices. We expect this will be facilitated by the SEC's new executive compensation disclosure requirements.

Lingering Concerns

As we noted above, the companion practice of spring-loading options grants should be further scrutinized. This involves the gaming of grants around the release of material non-public information. Studies suggest this has been rampant for many years and it happens regardless of whether grant dates are fixed annually or at the discretion of management or directors. The protections offered by the Sarbanes Oxley accelerated Form 4 filing, does not address this. While the latest executive compensation disclosure requirements of the SEC do require a full review and report by the compensation committee on any spring-loading activities, it does not prohibit them. We would encourage a closer look at whether officers and directors in control of the option granting process should be barred from participating in any spring-loaded grants, just as they would be prohibited from trading in any other company securities while in the possession of inside information.

We have one additional concern. We believe that one facilitator of backdating was accounting rules that failed to result in fair value expensing of the cost of the options. As we have said, auditors apparently failed to consider such off-balance-sheet (OBS) items of sufficiently high risk to warrant full scrutiny and thorough audits of the option grants. Many more items, several of considerable size relative to most companies' balance sheets, remain off-balance-sheet and unexpensed, and reported if at all, in the notes. We would hope that auditors would learn from the lessons of the 2001–2002 corporate collapses involving large OBS transactions and the backdating/spring-loading problems currently receiving scrutiny and tighten their procedures to make certain that these receive the same attention as items required to be expensed.

Conclusion

We commend the members of the Committee for your continued attention and leadership on this unethical industry practice. In summary, we encourage three further steps.

1. Consideration of a possible ban on spring loading for named executives and directors.
2. A closer look by auditors and regulators for any irregularities in the granting process used for restricted stock.
3. A bolstering of audit procedures to include a closer review of any other off balance sheet items posing similar risks of being misreported.

Our markets can ill afford further lapses in the ethics relating to executive compensation or the integrity of financial reporting. We have been down that market–paralyzing road before.

PREPARED STATEMENT OF RUSSELL READ

CHIEF INVESTMENT OFFICER, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

SEPTEMBER 6, 2006

Chairman Shelby, Senator Sarbanes and members of the Senate Banking Committee, I am pleased to be here today to provide an institutional investor's perspective on the important topic of stock option backdating and spring loading.

I am Russell Read, Chief Investment Officer with the California Public Employees' Retirement System (CalPERS). As you know, CalPERS is the nation's largest public pension system with more than $209 billion in assets. We have long been a voice for corporate governance. We are committed to executive compensation reform, to full disclosure and transparency of financial information, and to director accountability.

The recent allegations around secret and even fraudulent backdating of options are disturbing. We appreciate your leadership, Mr. Chairman, in calling for this hearing and for your personal commitment and the commitment of the Senate Banking Committee toward addressing this problem.

CalPERS believes that as part of a good executive compensation policy, stock options are appropriate. They align employees' interest with that of the shareowners. But when options are hidden from view, and when the option awards themselves do not tie to performance, it creates a serious problem.

As you know, CalPERS size does not lend itself to selling our stocks in troubled companies. As a large institutional investor, we don't have the luxury of not showing up for the ballgame. Baseball fans can choose to stay home, but as the steward for so many public servants who depend on us for their retirement security, we cannot.

If we are out of the ball game, we can't produce the investment returns that cover $3 of every $4 of our people's retirement benefits.

When an executive takes stealth payments that we can't trace, when companies make false statements and omit material facts concerning backdating of option grants, billions of dollars can be inappropriately given and once the truth of such option grant practices are made, it can cause the company's stock to fall precipitously. This directly hurts the retirement security of ordinary Americans. In CalPERS case, we're talking about clerks, custodians, school bus drivers, firefighters, and highway repair people, for example.

Since this issue has come to light, an unprecedented number of late filings with the SEC have occurred, which of course, delays disclosure to shareowners.

Secondly, these late filings are often considered to be technical violations of the conditions of borrowing, and that is costing companies too.

Last month, the Wall Street Journal reported that some bondholders are calling in their loans or demanding payment or large fees in exchange for an extension of their default deadlines. As many as two dozen companies were reported to have faced this dilemma over the past 18 months, and some had to pay multi-million dollar fees.

Even more astonishing, as the Wall Street Journal also reported, we are now learning that as stocks sank after the terrorist attacks of September 11, scores of companies rushed to issue options to top tier executives when the stock market had reached its post-attack low on September 21, 2001.

Now comes a cascade of class action and shareowner derivative lawsuits.

Once again, this scandal has brought back a number of fundamental corporate governance questions, such as:

1. Are Boards condoning this behavior?
2. If not—and the Boards are themselves surprised to learn of questionable backdating—then the question is where was their oversight?
3. It raises questions about adequate internal and external auditor controls. Are the auditors being vigorous enough in their examination of a company's option granting practices?
4. And finally, investors want to know if illegalities are occurring, will the wrongdoers be swiftly and aggressively prosecuted, and will they be held accountable with civil and criminal penalties where appropriate?

Mr. Chairman, you hit the nail on the head when you said that if the public is to maintain full confidence in our public markets, the appropriate action needs to occur.

Over the last two months, we have approached 42 portfolio companies under investigation by the SEC. We have asked that companies perform independent inves-

tigations and that they publicly disclose all findings resulting from such investigations, regardless of the outcome.

We have urged company boards of directors to develop policies that disclose how stock option grant dates are established and then publicly disclose those policies in company financial and proxy statements.

We want Company Boards and Compensation Committees to conduct an audit of their executive compensation plan administrator to be sure they are acting in full compliance with their directives.

And we strongly believe something needs to be done to be sure that company resources are *not* used to satisfy the tax and legal liability of executives implicated for this kind of wrongdoing. Such an inappropriate use of corporate assets hurts shareowners twice—once by the fruits of such backdating, and the other when they are allowed to use company assets to defend their actions.

We urge the Committee to call on the SEC to continue to investigate, and to aggressively prosecute wrongdoing.

We believe the SEC has the authority it needs to solve this problem. But we think they need to be more aggressive in enforcing rules for the filing of Forms 3, 4 and 5. SEC rules require company stock sales to be reported on SEC Forms within two days of the date of execution. SEC rules also require two-day reporting of certain transactions between employee benefit plans by officers and directors and that transactions involving stock options such as grants, awards, cancellations and repricing be reported in the same time frame.

We welcome the Public Accounting Standards Board's help by providing greater oversight of auditing practices pertaining to option grants. Their July 28th practice alert is very beneficial, and we welcome their continued oversight.

I would like to close by giving our view of the issue of spring loading of options.

We believe the SEC's requirement that an issuer disclose its option grants policy will have a positive effect. It should mitigate the activity of spring loading options in the future. However, should this not prove to be the case, we recommend that the SEC take additional steps to ensure that option grant practices are carried out in a systematic fashion, unaffected by the timing and release of material non-public information.

To sum up, we are going to do our part as active shareowners to hold Boards of Directors and Compensation Committees accountable. We will work with the SEC and the PCAOB in whatever way they deem helpful, and of course, we stand ready to assist this Committee by providing additional information. Finally, on behalf of the 1.4 million public servants we represent, I want to thank you once again, Mr. Chairman for all that you and this Committee are doing to restore the public trust in our financial markets.

I would be pleased to answer any questions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM CHRISTOPHER COX

Q.1. In your testimony you discuss the new disclosures mandated by the recently adopted SEC executive compensation rules and say that "if a company has a plan to issue option grants in coordination with the release of material non-public information, that will now be clearly described" in proxy statements approved by shareholders. Chairman Cox, if a company were to time an options grant before announcing unexpectedly high quarterly earnings, and this was fully consistent with the material terms of the options plan and the executive compensation rules, would there be any violation of SEC rules or the securities laws?

A.1. If a company times option grants in coordination with the release of material non-public corporate information and that practice is consistent with the material terms of its options plan and is fully disclosed pursuant to the Commission's executive compensation rules, the fact that a grant coincided with the announcement of unexpectedly high earnings would not, in and of itself, suggest a violation of the federal securities laws. Other circumstances surrounding a fortuitously timed option grant, however, could implicate potential securities law violations. Each case would have to be evaluated on its own facts and circumstances.

Q.2. The Sarbanes-Oxley provision shortening the time for reporting option grants to two business days, along with the Financial Accounting Standards Board expensing rule, helped to significantly reduce fraudulent backdating activity. I would make the observation that in order for the SOX provision to serve as an effective deterrent, however, there must be sanctions for failing to meet the two day requirement under Form 4. What is the percentage of Form 4 filings that are submitted outside the two day window and what are the sanctions for such late filings, particularly for repeat offenders?

A.2. Our staff has been working to better understand the extent to which filers are not meeting their reporting obligations for stock option grants, focusing on Forms 4 filed through our EDGAR system from July 2005 to June 2006. In general, the staff concluded that grants to executives at large corporations, defined for these purposes as those with market capitalizations of $750 million or more, are by and large timely reported. Over 93% of filings by these companies met the two business day reporting deadline, and over 96% were filed within five days of option grant. The staff did, however, find higher rates of late filing among smaller issuers, with about 83% of the forms associated with these companies being filed on time and over 88% filed within five days of option grant. We note that in some cases, a Form 4 may appear to have been filed late, but because of discrepancies in the manner in which the filer completes the form, it may actually have been filed on time.

As with all violations of our rules, the remedies depend upon the individual facts and circumstances in each case. In particular, Enforcement actions involving late Section 16 filings also may involve other securities law violations. Depending upon the specific facts, violators may be ordered to cease and desist, be enjoined, or be assessed civil monetary penalties.

RESPONSE TO WRITTEN QUESTION OF SENATOR BUNNING FROM CHRISTOPHER COX

Q.1. Some concerns have been raised about IRS cooperation with the SEC in efforts to focus on the tax returns of companies that have admitted to backdating. To what degree is the SEC coordinating with the IRS on this issue?

A.1. The Commission has granted the IRS access to our investigative files in a number of our options backdating investigations. In addition, Commission staff have met with IRS staff to determine how best to communicate and share appropriate additional information.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM MARK OLSON

You have asked us to respond to two questions from Senator Bunning for the record of the Committee on Banking, Housing, and Urban Affairs' September 6th hearing on Stock Options Backdating. Our responses to the questions appear below.At the outset, we should note that, under the Sarbanes-Oxley Act of 2002, the PCAOB's mission is to oversee the auditors of public companies. Since 1973, the Financial Accounting Standards Board ("FASB") has been the designated organization in the private-sector for establishing financial accounting standards. Accordingly, the answers below reflect our understanding of FASB's (and its predecessor's) reasons for their decisions.

Q.1. Because options have vesting periods and there is no ability to cash out immediately for profit, I am curious why the FASB ever made the decision to treat "at the money" and "in the money" options differently; that is, to treat one as valuable and one as valueless when it comes to expensing. To what degree do you think that decision contributed to the practice of back-dating?

A.1. This question requires insight into the deliberations of the accounting standard setters in their work to establish standards of financial accounting and reporting which govern the preparation of financial reports. The Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) issued pronouncements on accounting principles until 1973. The APB was replaced by the FASB. Accounting Principles Board Opinion No. 25 (1972) ("APB No. 25") required companies to use the "intrinsic value" method for determining the compensation cost of an employee stock option. According to this method, as described in APB No. 25, "compensation cost is measured by the difference between the quoted market price of the stock at the date of grant or award and the price, if any, to be paid by an employee." When it issued APB No. 25, the Accounting Principles Board noted that the value of an option is also affected by, among other factors, restrictions on transferability and the differentrisk profiles of an option and the stock underlying it. It decided, however, that, the effects of these factors were difficult to measure, and that the intrinsic value method was therefore a more practical approach. In 1995, FASB adopted Statement of Financial Accounting Standards No. 123, Share-Based Payments ("FAS 123"), which encouraged companies to use the "fair value" method to account for employee stock options. Accord-

ing to that method, the fair value of an option is estimated using an option-pricing model, such as the Black-Scholes model. FASB noted when it adopted FAS 123 that since 1972, when APB No. 25 was issued, options trading had increased significantly and mathematical models had been developed to estimate their fair value. According to FAS 123, these option-pricing models allow the fair value of an option to be determined with sufficient reliability to justify recognition in financial statements. Under FAS 123R, which FASB issued in 2004, companies are required to use the fair value method.Senator Bunning also asks whether the different accounting treatment of "at the money" and "in the money" employee stock options contributed to the practice of backdating. As noted in the PCAOB's written testimony for the hearing, by permitting companies not to record any cost when employee stock options were granted at a price equal to or greater than the market price on the date of the grant, APB No. 25 discouraged companies from granting options at less than the prevailing market price, although such discounted options could be more lucrative for recipients. Some companies may have granted options atprices below market on the grant date but treated them, in contravention of accounting principles, for accounting and tax purposes as if they were granted on a date when market prices were lower. The adoption of FAS 123R seems to have significantly reduced companies' incentive to backdate employee share option grants.

Q.2. Last week, a Wall Street Journal article highlighted a statement by Milton Friedman and many others advocating the end of the expensing of options, stating that expensing is bad accounting. Their argument is that expensing misstates the nature of the transaction, which is a transfer outside the business from the owners to the employees, rather than through the business. I am interested to hear your thoughts on this idea.

A.2. The FASB considered this argument during the development of FAS 123 and again with FAS 123R. After following its due process procedures, which include an opportunity for public comment, FASB concluded that a company's receipt of an employee's services in exchange for an equity instrument (employee share options) was an event that gave rise to compensation cost. One basis for this conclusion was that determining whether to record a compensation cost should depend on whether the employee performed services for the company in exchange for compensation and not on the nature of the consideration that was paid to the employee.With respect to the specific argument that the award of employee share options is a transfer outside the business from the owners to the employees, FASB noted -Some who do not consider [expensing] to be appropriate contend that the issuance of an employee share option is a transaction directly between the recipient and the preexisting shareholders. The Board disagrees. Employees provide services to the entity-not directly to individual shareholders-as consideration for their options. Carried to its logical conclusion, that view would imply that the issuance of virtually any equity instrument for goods or services, rather than for cash or other financial instruments, should not affect the issuer's financial statements. For example, no asset or related cost would be reported if shares of stock were issued to acquire legal or consulting services, tangible assets,

or an entire business in a business combination. To omit such assets and the related costs would give a misleading picture of the entity's financial position and financial performance. FAS 123R, Paragraph B20.

RESPONSE TO WRITTEN QUESTION OF SENATOR BUNNING FROM ERIK LIE

Q.1. Last week, a Wall Street Journal article highlighted a statement by Milton Friedman and many others advocating the end of the expensing of options, stating that expensing is bad accounting. Their argument is that expensing misstates the nature of the transaction, which is a transfer outside the business from the owners to the employees, rather than through the business. I am interested to hear your thoughts on this idea.

A.1. I believe that options should be expensed. I understand the arguments put forth by Milton Friendman and others, and I think it is quite reasonable. However, I do not think it should matter for accounting reasons whether the compensation comes via cash or options. One could argue that unlike cash compensation, option compensation is a form of gain-sharing instrument that does not represent a direct cost to the company. But in either case, the shareholders, as the owners of the company, bear the cost of the compensation, and this should be explicitly recognized.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

COUNCIL OF INSTITUTIONAL INVESTORS
Washington, D.C., September 8, 2006

The Honorable RICHARD C. SHELBY
Committee on Banking, Housing, and Urban Affairs
United States Senate
SD–534 Dirksen Senate Office Building
Washington, D.C. 20510-6075

Re: September 6, 2006, Hearing of the Committee on Banking, Housing, and Urban Affairs on Stock Options Backdating

Dear Mr. Chairman:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 130 public, corporate and union pension funds with combined assets of over $3 trillion. We applaud your decision to have held the above referenced hearing on a very important and timely issue of great interest to our members in their role as institutional investors. We respectfully request that this letter be made a part of the official hearing record.

The Council believes that executive compensation is a critical and visible aspect of a company's governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board. And they have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for employees, signaling the market and affecting employee morale.

Well designed executive stock compensation programs can lead to superior performance when structured to achieve appropriate long-term objectives and align executives' interests with those of the shareowners. Those programs, however, as evidenced by stock options backdating, can also be abused, undermining the purpose and potential benefits of stock compensation.

We share your view that that stock options backdating "hurts the capital markets . . . [and] destroys confidence in our system." [1] We also appreciate and support your interest in ensuring that the Securities and Exchange Commission ("SEC") has the necessary resources and authority to address the issues raised by stock options backdating and other potential executive compensation abuses that may arise in the future.

Many of the parties that participated in stock options backdating activities appear to have been motivated by the desire to provide extra compensation to certain executives without: (1) requiring any performance from the executives in return for the extra compensation; (2) requesting approval or even informing existing or potential shareowners that the extra compensation was being granted; and (3) reporting the extra compensation as a cost or expense, and thereby overstating the company's earnings to market participants.

In addition to violating the federal securities laws that were designed to protect investors, stock options backdating activities also appear to have violated a number of the Council's recommended "Corporate Governance Policies," including the following:

> **Performance options:** Stock option prices should be . . . based on the attainment of challenging quantitative goals.
>
> **Stock option expensing:** Since stock options have a cost, companies should include these costs as an expense on their reported income statements and disclose valuation assumptions.
>
> **Grant timing:** Except in extraordinary circumstances, such as a permanent change in performance cycles, long-term incentive awards [including stock compensation] should be granted at the same time each year.
>
> **Award specifics:** Compensation committees should disclose the . . . performance criteria and grant timing of . . . [stock compensation] granted . . . and how each component contributes to long-term performance objectives of a company.

For your information, given our members' significant interest in stock options backdating, in June 2006 the Council sent letters to the 1,500 largest U.S. companies by market capitalization asking those companies to explain: (1) how they granted equity awards; (2) whether they were conducting an internal review of past stock option practices; and (3) whether they were under investigation by the SEC or any

[1] Vineeta Anand and Jesse Westbrook, "Congress Wants to Ensure SEC Has Funds to Police Option Awards," *Bloomberg.com* (September 6, 2006).

other law enforcement agency for stock option-related practices. To-date we have received over 220 responses. The responses are available on the Council's website at *www.cii.org*. We would welcome the opportunity to share our analysis of the responses with the Committee upon request.

We again want to thank you for holding a hearing on stock options backdating and appreciate the opportunity to provide the Committee with our views on the issue. We look forward to continuing to work with you, Ranking Member Sarbanes, other Members of the Committee, the SEC, and the Public Company Accounting Oversight Board on issues relating to stock option backdating and other issues of importance to our nation's investors.

Sincerely,

JEFF MAHONEY
General Counsel

cc: The Honorable Paul S. Sarbanes, Ranking Member, Committee on Banking, Housing, and Urban Affairs

The Honorable Christopher Cox, Chairman, United States Securities and Exchange Commission

The Honorable Mark W. Olson, Chairman, Public Company Accounting Oversight Board